Supreme Court of the United States

OCTOBER TERM, 1964

No. 628

UNITED STATES, PETITIONER

vs.

MIDLAND-ROSS CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

INDEX

[fol. A] No. 15,524.

IN THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MIDLAND-ROSS CORPORATION, PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

ON APPEAL FROM
THE JUDGMENT OF THE UNITED STATES DISTRICT COURT,
FOR THE NORTHERN DISTRICT OF OHIO

APPENDIX TO THE BRIEF FOR THE DEFENDANT-APPELLANT
—Filed October 12, 1963

* * * *

[File Endorsement Omitted]

[fols. 1-2] * * *

[fol. 3]

* * * *

IN UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF OHIO

No. 36,611

INDUSTRIAL RAYON CORPORATION, PLAINTIFF

v.

UNITED STATES OF AMERICA, DEFENDANT

COMPLAINT—Filed January 9, 1961

COUNT I.

1. Plaintiff is, and at all times referred to herein, has been a corporation organized under and by virtue of the laws of the State of Delaware, with its principal office in

the Eastern Division of the Northern District of Ohio at 660 Union Commerce Building, Cleveland, Ohio.

2. This is an action against the defendant pursuant to Section 1346(a)(1) of Title 28 of the United States Code, Act of June 25, 1948, c. 646, 62 Stat. 933, as amended by the Act of July 30, 1954, c. 648, Section 1, 68 Stat. 589, to recover income tax, excess profits tax and [fol. 4] interest erroneously, illegally and excessively assessed and collected together with interest thereon.

3. Plaintiff duly filed with the District Director of Internal Revenue at Cleveland, Ohio, for the calender year 1952 its United States Corporate Income and Excess Profits Tax Return on June 15, 1953 showing income and excess profits tax due in the amount of $10,964,532.37. Such amount was paid on or before the dates shown below as follows:

March 15, 1953	$4,500,000.00
June 15, 1953	4,271,625.90
September 15, 1953	1,096,453.24
December 15, 1953	1,096,453.23

4. Upon examination of said tax return for 1952 defendant's agents asserted a deficiency in tax for the year 1952 of $298,412.71. On or about June 14, 1957 plaintiff paid defendant's authorized representative the full amount of the asserted deficiency plus interest of $76,025.75, making a total of $374,438.46.

5. On or about March 14, 1958 plaintiff duly filed with the District Director of Internal Revenue, Cleveland, Ohio, its claim for refund of United States income and excess profits tax for the year 1952 in the amount of $111,718.24 or such greater amount as was legally refundable plus interest as provided by law. A copy of said claim for refund is attached hereto and made a part hereof as Exhibit A. On or about June 9, 1958 plaintiff duly filed with the District Director of Internal Revenue, Cleveland, Ohio, an amended claim for refund of United States income and excess profits tax for the year 1952 in the amount of $130,813.27 or such greater amount as was legally refundable plus interest as provided by law. A copy of said amended claim for refund is attached hereto and made a part hereof as Exhibit B.

6. On or about January 14, 1959 plaintiff executed and duly filed a Waiver of Registered Mail Notification of Claim Disallowance (Form 2297) with respect to its above described claim for refund.

[fol. 5] 7. During the year 1952 plaintiff had gains from the sale of certain non-interest bearing notes some of which it had held for more than six months and some of which it had held for less than six months. Such notes were held by plaintiff as investments and constituted capital assets in its hands. On its income and excess profits tax return for the year 1952 plaintiff properly reported the gain on the sales of such notes held for more than six months as long term capital gain. It properly reported the gain on the sales of such notes held for less than six months as short term capital gain. A description of the notes and the sales setting forth the amounts of such gains is attached hereto and made a part hereof as Exhibit C.

8. Upon examination of plaintiff's 1952 United States income and excess profits tax return defendant, through its agents, erroneously treated gain upon the sale of the notes described in paragraph 7 as interest income, included the entire gain in plaintiff's gross income, and disallowed an excess profits credit carryback from 1953 because of his adjustment and a similar adjustment for 1953 as more fully set forth in Count II hereof. Plaintiff has paid the full tax determined upon such basis.

9. Plaintiff has overpaid and defendant and its representatives have illegally assessed, collected and retained from plaintiff an amount as United States income and excess profits tax for 1952 which is erroneously and illegally excessive by at least $130,813.27 plus interest paid thereon of $33,326.92, and defendant and its representatives have at all times erroneously and illegally refused to refund to plaintiff the said sums together with interest as determined by law.

COUNT II.

10. Plaintiff realleges and incorporates herein by reference each and every allegation contained in paragraphs 1 and 2 as hereinabove set forth.

11. Plaintiff duly filed with the District Director of Internal Revenue at Cleveland, Ohio, for the calendar year [fol. 6] 1953 its United States Corporate Income Tax Return on or before September 10, 1954 showing income tax (but no excess profits tax) due in the amount of $9,585,540.69. Such amount was paid as follows:

March 15, 1954	$4,410,000.00
June 15, 1954	4,410,000.00
September 15, 1954	286,263.66
December 15, 1954	479,277.03

12. Upon examination of said tax return for 1953, defendant's agents asserted a deficiency in tax for the year 1953 of $36,927.93 (including excess profits tax). On or about June 14, 1957 plaintiff paid defendant's authorized representative the full amount of the asserted deficiency plus interest of $7,198.42, making a total of $44,126.35.

13. On or about March 14, 1958 plaintiff duly filed with the District Director of Internal Revenue, Cleveland, Ohio, its claim for refund of United States income and excess profits tax for the year 1953 in the amount of $38,060.56 or such greater amount as was legally refundable plus interest as provided by law. A copy of said claim for refund is attached hereto and made a part hereof as Exhibit D. On or about June 9, 1958 plaintiff duly filed with the District Director of Internal Revenue, Cleveland, Ohio an amended claim for refund of United States income and excess profits tax for the year 1953 in the amount of $18,965.52 or such greater amount as was legally refundable plus interest as provided by law. A copy of said amended claim for refund is attached hereto and made a part hereof as Exhibit E.

14. On or about January 14, 1959 plaintiff executed and duly filed a Waiver of Registered Mail Notification of Claim Dissallowance (Form 2297) with respect to its above described claim for refund.

15. During the year 1953 plaintiff had gains from the sale of certain non-interest bearing notes which it had held for more than six months. Such notes were held by plaintiff as investments and constituted capital assets in

its hands. On its income and excess profits tax return for [fol. 7] the year 1953 plaintiff properly reported the gain on the sales of such notes as long term capital gain. A description of the notes and the sales setting forth the amounts of such gains is attached hereto and made a part hereof as Exhibit C.

16. Upon examination of plaintiff's 1953 United States income and excess profits tax return defendant, through its agents, erroneously treated gain upon the sale of the notes described in paragraph 15 as interest income and included the entire gain in plaintiff's gross income. Plaintiff has paid the full tax determined upon such basis.

17. Plaintiff has overpaid and defendant and its representatives have illegally assessed, collected and retained from plaintiff an amount as United States income and excess profits tax for 1953 which is erroneously and illegally excessive by at least $18,965.52 plus interest paid thereon of $3,696.98 and defendant and its representatives have at all times erroneously and illegally refused to refund to plaintiff the said sums together with interest as determined by law.

COUNT III.

18. Plaintiff realleges and incorporates herein by reference each and every allegation contained in paragraphs 1 and 2 as hereinabove set forth.

19. Plaintiff duly filed with the District Director of Internal Revenue at Cleveland, Ohio, for the calendar year 1954 its United States Corporate Income Tax Return on or before September 15, 1955 showing income tax due in the amount of $7,899,797.87. Such amount was paid as follows:

March 15, 1955	$3,937,500.00
June 15, 1955	3,965,000.00

(The overpayment of $2,702.13 was credited against 1955 income tax liability.)

20. Upon examination of said tax return for 1954 defendant's agents asserted an overassessment of tax for [fol. 8] the year 1954 of $5,606.79. On or about July 12, 1957 defendant's authorized representative paid plaintiff

the full amount of the asserted overassessment plus interest of $678.34, making a total of $6,285.13.

21. On or about March 14, 1958 plaintiff duly filed with the District Director of Internal Revenue, Cleveland, Ohio, its claim for refund of United States income tax for the year 1954 in the amount of $5,660.42 or such greater amount as was legally refundable plus interest as provided by law. A copy of said claim for refund is attached hereto and made a part hereof as Exhibit F.

22. On or about January 14, 1959 plaintiff executed and duly filed a Waiver of Registered Mail Notification of Claim Dissallowance (Form 2297 with respect to its above described claim for refund.

23. During the year 1954 plaintiff had gains from the sale of certain non-interest bearing notes which it had held for over six months. Such notes were held by plaintiff as investments and constituted capital assets in its hands. On its income tax return for the year 1954 plaintiff properly reported the gain on the sales of such notes as long-term capital gain. A description of the notes and the sales setting forth the amount of such gain is attached hereto and made a part hereof as Exhibit C.

24. Upon examination of plaintiff's 1954 United States income and excess profits tax return defendant, through its agents, erroneously treated gain upon the sale of the notes described in paragraph 23 as interest income and included the entire gain in plaintiff's gross income. Plaintiff has paid the full tax determined upon such basis.

25. Plaintiff has overpaid and defendant and its representatives have illegally assessed, collected and retained from plaintiff an amount as United States income and excess profits tax and interest for 1954 which is erroneously and illegally excessive by at least $5,660.42 and defendant and its representatives have at all times erroneously and illegally refused to refund to plaintiff the said sum of $5,660.42 together with interest as determined by law.

[fol. 9] WHEREFORE, plaintiff demands judgment against defendant in the sum of $192,463.11 or in such other amount as the Court may find justly owing by defendant

to plaintiff with interest as allowed by law and its costs herein, together with such other and further relief as the Court may deem just and proper.

THEODORE M. GARVER,
EBEN H. COCKLEY,
Attorneys for Plaintiff.

JONES, DAY, COCKLEY & REAVIS,
Of Counsel.

IN UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO

ANSWER—Filed March 9, 1961

Now comes the defendant, the United States of America, by its attorney, Russell E. Ake, United States Attorney for the Northern District of Ohio, and for its answer:

COUNT I.

I. Admits the averments contained in paragraph 1 of the complaint, except that defendant is without knowledge or information sufficient to form a belief as to the truth of the averment of the location of the principal office of the plaintiff.

II. Admits the averments contained in paragraph 2 of the complaint, except denies the averment that the taxes and interest were erroneously, illegally and excessively assessed and collected.

III. Admits the averments contained in paragraph 3 of the complaint, except denies the dates of payment as averred in paragraph 3. Defendant avers that such payments were made as follows:

[fol. 10]

March 12, 1953	$4,500,000.00
June 19, 1953	4,271,625.90
September 18, 1953	1,096,453.24
December 21, 1953	1,096,453.23

IV. Admits the averments contained in paragraph 4 of the complaint, except denies the date of payment was

June 14, 1957. Defendant avers that the date of payment was June 27, 1957.

V. Admits the averments contained in paragraph 5 of the complaint, except:

(a) Denies that the date of filing of the original claim for refund was March 14, 1958. Defendant avers that the date of such filing was March 17, 1958.

(b) Denies the averments and facts contained in the claims for refund attached to the complaint as Exhibits A and B unless otherwise expressly admitted herein.

VI. Admits the averments contained in paragraph 6 of the complaint.

VII. Denies the averments contained in paragraph 7 of the complaint (including the averments contained in Exhibit C, unless otherwise expressly admitted herein), except the defendant admits that plaintiff realized a profit on the sale of certain notes during the taxable year.

VIII. Admits the averments contained in paragraph 8 of the complaint, except denies that defendant, through its agents, acted erroneously.

IX. Denies the averments contained in paragraph 9 of the complaint.

COUNT II.

X. Admits the everments contained in paragraph 10 of the complaint, except:

(a) The defendant is without knowledge or information sufficient to form a belief as to the truth [fol. 11] of the averment of the location of the principal office of the plaintiff.

(b) Denies the averment that the taxes and interest were erroneously, illegally and excessively assessed and collected.

XI. Admits the averments contained in paragraph 11 of the complaint, except denies that the payment of $479,-277.03 was made on December 15, 1954. Defendant avers that such payment was made on December 21, 1954.

XII. Admits the averments contained in paragraph 12 of the complaint, except denies that the date of payment was June 14, 1957. Defendant avers the date of payment was June 27, 1957.

XIII. Admits the averments contained in paragraph 13 of the complaint, except:

(a) Denies the date of filing of the original claim for refund was March 14, 1958. Defendant avers that the date of such filing was March 17, 1958.

(b) Denies the averments and facts contained in the claims for refund attached to the complaint as Exhibits D and E, unless otherwise expressly admitted herein.

XIV. Admits the averments contained in paragraph 14 of the complaint.

XV. Denies the averments contained in paragraph 15 of the complaint (including the averments contained in Exhibit C, unless otherwise expressly admitted herein), except the defendant admits that plaintiff realized a profit on the sale of certain notes during the taxable year.

XVI. Admits the averments contained in paragraph 16 of the complaint, except denies that defendant, through its agents, acted erroneously.

XVII. Denies the averments contained in paragraph 17 of the complaint.

[fol. 12]

COUNT III.

XVIII. Admits the averments contained in paragraph 18 of the complaint, except:

(a) The defendant is without knowledge or information sufficient to form a belief as to the truth of the averment of the location of the principal office of the plaintiff.

(b) Denies the averment that the taxes and interest were erroneously, illegally and excessively assessed and collected.

XIX. Admits the averments contained in paragraph 19 of the complaint, except defendant is without knowledge or information sufficient to form a belief as to the

truth of the averment that the overpayment of $2,702.13 was credited against 1955 income tax liability.

XX. Admits the averments contained in paragraph 20 of the complaint, except defendant is without knowledge or information sufficient to form a belief as to the truth of the averment that defendant's authorized representative paid plaintiff the full amount of the asserted overassessment plus interest of $678.35.

XXI. Admits the averments contained in paragraph 21 of the complaint, except:

(a) Denies the date of filing of the claim for refund was March 14, 1958. Defendant avers that the date of such filing was March 17, 1958.

(b) Denies the averments and facts contained in the claim for refund attached to the complaint as Exhibit F unless otherwise expressly admitted herein.

XXII. Admits the averments contained in paragraph 22 of the complaint.

XXIII. Denies the averments contained in paragraph 23 of the complaint (including the averments contained in Exhibit C, unless otherwise expressly admitted herein), except the defendant admits that plaintiff realized a profit on the sale of certain notes during the taxable year.

[fol. 13] XXIV. Admits the averments contained in paragraph 24 of the complaint, except denies that defendant, through its agents, acted erroneously.

XXV. Denies the averments contained in paragraph 25 of the complaint.

WHEREFORE, defendant, having answered fully, prays that judgment be entered dismissing plaintiff's complaint with prejudice and that defendant be awarded its costs and such other relief which to the Court may seem just and proper.

....

United States Attorney.

IN UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF OHIO

ORDER SUBSTITUTING MIDLAND-ROSS CORPORATION AS PLAINTIFF—Entered May 1, 1962

Upon consideration,

IT IS ORDERED that plaintiff's motion to substitute party plaintiff herein is granted.

IT IS, THEREFORE, ORDERED that Midland-Ross Corporation is hereby substituted for Industrial Rayon Corporation as the plaintiff in this action.

(s) JAMES C. CONNELL,
Chief Judge.

IN UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF OHIO

STIPULATION OF FACTS—Filed June 21, 1962

The parties to this action, by their respective counsel, hereby stipulate, for the purposes of this action only, without waiving any right to object to the admissibility or relevancy of any facts set forth herein, and without prejudice to the right of either party to submit other or further [fol. 14] evidence not inconsistent with the facts hereby stipulated, to the truth of the following facts:

1. This Court has jurisdiction of the subject matter of this action and of the parties to this action.

2. On March 28, 1961 the original Plaintiff in this action, Industrial Rayon Corporation (hereinafter called "Industrial"), was merged into Midland-Ross Corporation under the provisions of Sections 1701.78 through 1701.81 of the Ohio Revised Code. Pursuant to the terms of said merger Midland-Ross Corporation was the surviving corporation of the merger and succeeded to all rights of industrial to all of its assets, claims or choses in action. At all times herein relevant the principal offices of both Industrial and Midland-Ross Corporation have been located in Cleveland, Ohio.

3. On June 27, 1957, Industrial paid to defendant $374,438.46, of which $298,412.71 was for United States income and excess profits taxes for the calendar year 1952, and $76,025.75 was for interest in respect of said taxes.

4. On March 17, 1958, Industrial timely filed with defendant a Claim for Refund, a copy of which is attached hereto marked "Exhibit 1," of $111,718.24 of the taxes set forth in paragraph 3 of this Stipulation. On June 9, 1958 Industrial filed with defendant an Amended Claim for Refund, a copy of which is attached hereto marked "Exhibit 2," of $130,813.27 of the taxes set forth in paragraph 3 of this Stipulation.

5. On January 14, 1959, Industrial executed and duly filed a Waiver of Registered Mail Notification of Claim Dissallowance (U. S. Treasury Department Form 2297) with respect to the Claims for Refund described in paragraph 4 of this Stipulation.

6. On June 27, 1957, Industrial paid defendant $44,-126.35, of which $36,927.93 was for United States income and excess profits taxes for the calendar year 1953, and $7,198.42 was for interest in respect of said taxes.

7. On March 17, 1958, Industrial timely filed with defendant a Claim for Refund, a copy of which is attached [fol. 15] hereto marked "Exhibit 3," of $38,060.56 of the taxes set forth in paragraph 6 of this Stipulation. On June 9, 1958, Industrial timely filed with defendant an Amended Claim for Refund, a copy of which is attached hereto marked "Exhibit 4," of $18,965.52 of the taxes set forth in paragraph 6 of this Stipulation.

8. On January 14, 1959, Industrial executed and duly filed a waiver of Registered Mail Notification of Claim Disallowance (U. S. Treasury Department Form 2297) with respect to the original and amended Claims for Refund described in paragraph 7 of this Stipulation.

9. On March 15, 1955, Industrial paid defendant $3,937,500 and on June 15, 1955, Industrial paid defendant $3,965,000, both of which payments were for United States income tax for the calendar year 1954. Industrial duly filed its United States Income Tax return for the calendar year 1954 on September 15, 1955. Of the total amount of $7,902,500 so paid, $8,308.92 was refunded or

credited to Industrial prior to March 17, 1958. On March 17, 1958, Industrial timely filed with defendant a Claim for Refund, a copy of which is attached hereto marked "Exhibit 5," of an additional $5,660.42 of the taxes set forth in paragraph 9 of this Stipulation.

10. On ~~January 14, 1959~~, Industrial executed and duly filed a Waiver of Registered Mail Notification of Claim Dissallowance (U. S. Treasury Department Form 2297) with respect to the claim for refund described in paragraph 8 of this Stipulation.

11. On January 29, 1952, Industrial paid $5,886,-666.66 to the General Motors Acceptance Corporation and received in return therefor three notes of the General Motors Acceptance Corporation, each in the face amount of $2,000,000 payable to bearer on October 27, 1952. Said notes were not in registered form and contained no provision for the payment of interest. Industrial sold one of the aforesaid notes to The National City Bank of Cleveland on October 8, 1952, for a price of $1,996,833.33, resulting in a gain to Industrial of $34,611.11. Industrial [fol. 16] sold the second of said notes to The Cleveland Trust Company on October 15, 1952, for a price of $1,-998,000 resulting in a gain to Industrial of $35,777.78. Industrial sold the third of said notes to the Union Bank of Commerce on October 16, 1952, for a price of $1,998,-166.66, resulting in a gain to Industrial of $35,944.44.

12. On January 29, 1952, Industrial paid $1,955,-416.67 to the Commercial Investment Trust Company and received in return therefor a note of the Commercial Investment Trust Company in the face amount of $2,000,-000, payable to the bearer on December 15, 1952. Said note was not in registered form and contained no provision for the payment of interest. On December 4, 1952, Industrial sold said note to the Union Bank of Commerce for a price of $1,998,166.67, resulting in a gain to Industrial of $42,750.

13. On January 11, 1952, Industrial paid $1,962,-222.22 to the Commercial Credit Company and received in return therefor a note of the Commercial Credit Company in the face amount of $2,000,000, payable to the bearer on October 9, 1952. Said note was not in registered form and

contained no provision for the payment of interest. On October 8, 1952, Industrial sold said note to The National City Bank of Cleveland for a price of $1,999,833.33, resulting in a gain to Industrial of $37,611.11.

14. On October 22, 1952, Industrial paid $996,166.66 to the Commercial Credit Company and received in return therefor a note in the face amount of $1,000,000, payable to the bearer on December 30, 1952 and in addition, on October 22, 1952 paid $996,166.67 to the Commercial Credit Company and received in return therefor another note, also in the face amount of $1,000,000 payable to the bearer on December 30, 1952. Said notes were not in registered form and contained no provision for the payment of interest. On December 22, 1952, Industrial sold one of said notes to The Cleveland Trust Company for the price of $999,333.33, resulting in a gain to Industrial of $3,166.67. On December 22, 1952, Industrial sold the [fol. 17] other of said notes to the Union Bank of Commerce for the price of $999,333.33, resulting in a gain to Industrial of $3,166.66.

15. On January 15, 1953, Industrial paid $982,385.42 to the Commercial Credit Company and received in return therefor a note of the Commercial Credit Company in the face amount of $1,000,000, payable to the bearer on October 9, 1953. Said note was not in registered form and contained no provision for the payment of interest. On September 30, 1953, Industrial sold said note to The National City Bank of Cleveland for the sum of $999,187.50, resulting in a gain to Industrial of $16,802.08.

16. On January 15, 1953, Industrial paid $982,385.42 to the Commercial Investment Trust Co. and received in return therefor a note of the Commercial Investment Trust Co. in the face amount of $1,000,000, payable to the bearer on October 9, 1953. Said note was not in registered form and contained no provision for the payment of interest. On September 30, 1953, Industrial sold said note to The National City Bank of Cleveland for a price of $999,187.50, resulting in a gain to Industrial of $16,802.08.

17. On February 17, 1953, Industrial paid $982,253.47 to the General Motors Acceptance Corporation and received in return therefor a note of the General Motors

Acceptance Corporation in the face amount of $1,000,000, payable to the bearer on November 13, 1953. Said note was not in registered form and contained no provision for the payment of interest. On November 9, 1953, Industrial sold said note to the Union Bank of Commerce for the price of $999,666.67, resulting in a gain to Industrial of $17,413.20.

18. On February 23, 1953, Industrial paid $982,358.42 to the General Motors Acceptance Corporation and received in return therefor a note of the General Motors Acceptance Corporation in the face amount of $1,000,000, payable to the bearer on November 17, 1953. Said note was not in registered form and contained no provision for the payment of interest. On November 9, 1953, Industrial sold said note to the Union Bank of Commerce for a price [fol. 18] of $999,333.33, resulting in a gain to Industrial of $16,947.91.

19. On June 1, 1954, Industrial paid $1,982,416.67 to the General Motors Acceptance Corporation and received in return therefor a note of the General Motors Acceptance Corporation in the face amount of $2,000,000, payable to the bearer on December 29, 1945. Said note was not in registered form and contained no provision for the payment of interest. On December 27, 1954, Industrial sold said note to The National City Bank of Cleveland for a price of $1,999,833.34, resulting in a gain to Industrial of $17,416.67.

20. On June 1, 1954, Industrial paid $495,583.33 to the Commercial Investment Trust, Inc., and received in return therefor a note of Commercial Investment Trust, Inc. in the face amount of $500,000, payable to the bearer on December 30, 1954. Said note was not in registered form and contained no provision for the payment of interest. On December 27, 1954, Industrial sold said note to The National City Bank of Cleveland for a price of $499,937.50, resulting in a gain to Industrial of $4,354.17.

21. The plaintiff objects to the admissibility of the statement in paragraphs 11 through 20 of this Stipulation that each of the notes described in such paragraphs was not in registered form, on the ground that such statement is irrelevant and immaterial.

22. In the case of each of the notes described in paragraphs 11 through 20 of this Stipulation, the amount paid by Industrial to the maker of the note was calculated by subtracting from the face amount of the note an amount determined by multiplying the face amount by an agreed percentage, dividing the product by 360 and multiplying the result by the number of days from the date of such payment to the maturity of the note. The agreed percentage was determined on the basis of the consideration of several factors, including the prevailing interest rates for borrowers with the credit standing of the obligor for notes of the duration involved and the availability and [fol. 19] need for cash funds. Although different emphasis may be placed on the varying factors in different situations, these are the same factors which Industrial and these makers normally consider in negotiating for the investment of funds and the securing of funds by borrowing or other means.

23. All the notes described in paragraphs 11 through 20 of this Stipulation were capital assets in the hands of Industrial which were sold in bona fide sales to the purchasers thereof.

24. In negotiating the sale price of the notes described in paragraphs 11 through 20, Industrial and the purchasers of the notes considered the face amount of the obligations, the credit of the obligor, the period of time between the purchase and the maturity of the notes, the prevailing interest rates, and the availability of cash funds. Although different emphasis may be placed on the varying factors in different situations, these factors plus the interest rate, if any, are the same factors which these purchasers normally consider in negotiating for the purchase of any corporate obligation. Upon consideration of these factors, the resulting price for the notes was then calculated on the basis of a specific yield, which varied from 1½% to 3% per 360 day year, to the purchaser for the period between the date of purchase and the maturity date of the note.

25. In deciding to sell the notes described in paragraphs 11 through 20 of this Stipulation instead of holding them to maturity, Industrial was motivated by a de-

sire to have the gain taxed as capital gain rather than as ordinary income. (Plaintiff objects to the admissibility in evidence of the facts set forth in this paragraph on the grounds that they are irrelevant, immaterial and incompetent.)

26. Industrial acquired and disposed of notes similar to those described in paragraphs 11 through 20 of this Stipulation regularly for several years prior to and following the years in issue. Such acquisitions, and the acquisition of the notes described in paragraphs 11 through 20 of this Stipulation, were made by Industrial for the purpose of temporary investment of funds not currently [fol. 20] required for its operations in such manner as to produce the maximum available contribution to net corporate earnings consistent with maximum liquidity and safety.

27. The gain to Industrial referred to in paragraphs 11 through 20 was included by Industrial in its federal income tax returns for the years 1952, 1953 and 1954 as capital gain, partly long term and partly short term. Following the audit of such returns by the Internal Revenue Service, all of such gain was included in Industrial's taxable income as ordinary income, and the resulting additional tax was paid as hereinabove set forth. If such gain is properly includable in taxpayer's income as capital gain, plaintiff is entitled to refunds of such taxes, the amount of which shall be computed by the parties, subject to the review of the Court.

THEODORE M. GARVER,
Attorney for Plaintiff,
Midland-Ross Corporation.

JONES, DAY, COCKLEY & REAVIS,
Of Counsel,

....
Attorney for Defendant.

IN UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF OHIO

MEMORANDUM ON TAX TREATMENT OF ORIGINAL ISSUE DISCOUNT—Filed March 11, 1963

KALBFLEISCH, *J.*

This is a suit to recover income and excess profits taxes for the years 1952, 1953 and 1954. The taxpayer is the Midland-Ross Corporation, successor in interest to the Industrial Rayon Corporation. During the period in question, for the purpose of temporarily investing funds not then currently required for its operation, the taxpayer [fol. 21] purchased thirteen notes, the face amounts of which varied from $500,000 to $2,000,000. These notes bore no interest, but rather were purchased at a discount by the taxpayer from the maker. Each of the notes was a time instrument.

Before maturity each note was sold to a financial institution at a price which was in excess of the price which had been paid to the maker but below the face amount.

The price paid by the taxpayer to the maker of each note was calculated by subtracting from the face amount a figure determined by multiplying the face amount by an agreed percentage, dividing the product by 360, and multiplying the result by the number of days from the date of such payment to the maturity of the note. The agreed percentage was determined on the basis of the consideration of several factors, including (1) the prevailing interest rates for notes of such duration made by borrowers with credit standings of the obligor, (2) the availability of such notes to prospective purchasers, and (3) the maker's need for cash funds. All of the notes were capital assets in the hands of the taxpayer and were sold by it in bona fide sales. In negotiating the sale price of the notes, the following factors were considered: (1) the face amounts of the obligations, (2) the credit rating of the obligor, (3) the period of time between the sale and the maturity of the notes, (4) the prevailing interest rates, and (5) the amount of cash funds available to the purchaser.

In this three-year period the taxpayer realized a total appreciation of more than $280,000 on these notes. It

contended that this appreciation was a capital gain, while the Internal Revenue Service contended that it was regular income. The taxpayer paid taxes at the regular income rate, and is here seeking a refund.

The relevant sections of the Internal Revenue Code are: Section 117(a)(1)(2) and (4) and Section 111(a) of the 1939 Code, and their counterparts in the Code of 1954.

Section 117(a)(1) of the 1939 Code defines a capital asset as:

[fol. 22] "* * * property held by the taxpayer (whether or not connected with his trade or business), but does not include * * *

> (D) an obligation of the United States or of any of its possessions, or of a state or territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue."

Subsections (2) and (4) of Section 117(a) provide that a capital gain is a gain from the sale of a capital asset, and Section 111(a) provides that the gain from the disposition of property is the "excess of the amount realized therefrom over the adjusted basis * * *."

Plaintiff stresses the fact that the language of the statute, especially of Section 117(a)(1) defining a capital asset, is broad and sweeping. It contends that because these notes were capital assets the gain realized thereon was a capital gain. It contends, further, that in view of Section 117(a)(1)(D), which specifically excludes certain types of discount paper from the category of capital assets, and in view of the failure to exclude such paper as these notes, the Congress clearly indicated its intention that the gain achieved on the sale of such notes constitutes capital gain under the maxim of *expressio unius est exclusio alterius.*

The taxpayer's contention is a familiar enough general rule of statutory construction. However, various courts have read certain exceptions into this statute. They have

held that, while it might appear that a literal construction of the statutory language would convert all but the specifically excluded gains into capital gains, the provisions must be construed in the light of their general purpose and the surrounding law. After so doing, these courts have read further exceptions into the statute, which have resulted in the exclusion from capital gains treatment of certain increments which a literal interpretation might in-[fol. 23] dicate were capital gains. See, for example, *Jaglom* v. *Commissioner*, 303 F. 2d 847 (2nd Cir., 1962); *United States* v. *Harrison*, 304 F. 2d 835 (5th Cir., 1962). In view of the fact that these statutory sections have not been interpreted to include all of the transactions which the sweeping scope of their language might indicate were within their purview, the Court is constrained to hold that this argument is not dispositive of the case.

The Government contends that the realized increment was in fact interest paid for the use of money, and was therefore regular income to the taxpayer. It contends that this is but another instance for application of the well recognized rule that when a taxpayer combines the sale of a right to receive ordinary income with the sale of a capital asset the ordinary income is not converted into a capital gain by its sale in combination with the capital asset. *Fisher* v. *Commissioner*, 209 F. 2d 513 (6th Cir., 1954), cert. den. 347 U. S. 1014; *Commissioner* v. *Morgan*, 272 F. 2d 936 (9th Cir., 1959); *Rosen* v. *United States*, 288 F. 2d 658 (3rd Cir., 1961); *United States* v. *Harrison*, 304 F. 2d 835 (5th Cir., 1962); and *United States* v. *Langston*, 308 F. 2d 729 (5th Cir., 1962).

The taxpayer does not dispute the general validity of this proposition. Its principal contention, however, is that the rule is inapplicable on these facts because the increment, for purposes of taxation at least, was not interest. It fully admits that if these notes had borne interest at a stated rate, and if it had then sold such notes before maturity at an increase in price, the amount of such increase allocable to the proportion of the interest earned to the date of sale would have been regular income under the rule of *Fisher* v. *Commissioner* and the other cases cited, *supra*. However, it contends that a different result is achieved when, instead of the notes bearing interest at

a fixed rate, they were originally sold at a discount. The taxpayer urges that there has been a continuous history of legislative, administrative and judicial interpretation since 1920 which has consistently held that original issue discount in the hands of a cash basis taxpayer is not in- [fol. 24] come, and that the appreciation resulting therefrom is not taxed as regular income but, rather, as a capital gain.

If it is true that historically the law has not considered such original issue discount as interest, but has removed it from the broad category of regular income and placed it within the specific classification of capital gain, then the increment in this case was not income and the general rule upon which the Government relies is inapplicable. The Court, therefore, must proceed to examine the treatment which such discount has traditionally received.

Commissioner v. *Caulkins*, 144 F. 2d 482 (6th Cir., 1944) is the primary cornerstone upon which the taxpayer rests its contention that the increment here involved was not, for taxation purposes at least, compensation for the use of its money. In that case the taxpayer had purchased an accumulative installment certificate under the terms of which he was to make periodic payments to the seller, who, at the end of ten years, would pay to the taxpayer the sum of $20,000.. This $20,000 was approximately $4,900 more than the total amount of the payments made to the seller. The Commissioner contended that this $4,900 was compensation for the use of the taxpayer's money, and was thus really interest. He held that this interest was regular income, although the taxpayer contended it was a capital gain.

The certificate involved in the *Caulkins* case was in registered form and the decision was based upon an interpretation of Section 117(f) of the Internal Revenue Code of 1939. Section 117(f) provided that amounts received by the holder of registered securities upon their retirement should be considered as amounts received in exchange therefor. The Court held that although the $4,900, at least in many respects, was similar to interest, it was an amount which was received in exchange for the sale of a capital asset and was therefore a capital gain.

To understand the *Caulkins* decision it is necessary to understand the history of Section 117(f). Before the enactment of that section it had been held that retirement of a bond was not such a sale or exchange as would [fol. 25] qualify the amount received upon the retirement for capital gains treatment. See *Fairbanks* v. *United States*, 306 U. S. 436 (1939). Section 117(f) was enacted to avoid this holding. It provided that amounts received upon the retirement of certain evidences of indebtedness which had interest coupons attached, or which were in registered form, should be considered as amounts received in exchange therefor. This provision enabled the amounts received upon the retirement of such bonds to qualify as capital gains. The taxpayer contends that this provision was enacted to accord the same tax treatment to such bonds upon their retirement as always had been accorded them on a sale before retirement. And, according to *Mertens Law of Federal Income Tax*, Volume 38, page 368, M 82:

> "The purpose underlying the enactment of Section 117(f) of the 1939 Code was to accord to the retirement of obligations similar treatment as was then, and is now, accorded to their sale or exchange."

In view of the purpose of Section 117(f), it appears that before the passage of that section amounts received upon the sale of such evidences of indebtedness did qualify for capital gains treatment. If a sale before maturity of such obligations did not permit increments to be accorded capital gains treatment, it is unlikely that the Congress would have deliberately enacted a provision according them such favorable treatment upon retirement.

From the combination of this legislative history with the *Caulkins* decision it is possible to draw the following analogy: Section 117(f), under the *Caulkins* holding, provided that all amounts received in exchange for the retirement of a qualifying capital asset were capital gains. Because Section 117(f) was meant to be declaratory of the preexisting law on sales before retirement, it follows that all amounts received on the pre-retirement sale of such debt obligations were likewise capital gains. The validity of this analogy must be tested by a further in-

[fol. 26] quiry into legislative, administrative and judicial history. However, before proceeding with that history it is necessary to examine the Government's position as to what the *Caulkins* case really held.

The Government contends that *Caulkins* was based solely upon an interpretation of Section 117(f). It says that the crucial fact in *Caulkins* was not that the debt obligations were discount obligations but that a retirement rather than a sale was involved. It has thus attempted to convince the Court that the *Caulkins* decision does not control this case, because in the present instance the notes were sold before maturity, rather than retired. It is true that the opinion in the *Caulkins* case primarily discusses the retirement factor; however, the Court is not convinced that increments on debt obligations which qualify under Section 117(f) would be accorded capital gains treatment if the obligations were retired, but would be taxed at regular income rates if they were sold before maturity. Even the Tax Court, which adopted that position in *Paine* v. *Commissioner*, 23 T.C. 391 (1954), Rev. 236 F. 2d 398 (8th Cir., 1956), and *Stanton* v. *Commissioner*, 34 T.C. 1 (1960), has now abandoned such a distinction. *Gibbons* v. *Commissioner*, 37 T.C. No. 57. The purpose of Section 117(f) surely was not to accord a more favorable tax treatment to income realized upon retirement of debt obligations than it would receive if they were sold before maturity. The quotation from *Mertens*, *supra*, also clearly indicates that such was not the case. Therefore, this Court is constrained to hold that the crucial fact in the *Caulkins* case was that the evidences of indebtedness were discount obligations.

The combination of the *Caulkins* case with Section 117(f) thus indicates that appreciation realized on evidences of indebtedness, issued at an original discount and sold before maturity, constituted a capital gain and not regular income. The remaining question, therefore, is whether the legislative, administrative and judicial treatments of discount obligations support this indication.

[fol. 27] The earliest administrative decision upon this matter which has been furnished to the Court is Office Decision 1024 published in Vol. 2, Cum. Bul. 189 (1920), holding that original issue discount on bonds was not in-

terest and, therefore, was not subject to special withholding provisions when the bonds were in the hands of foreign corporations. It is true, as the Government contends, that this opinion was not concerned with whether an appreciation resulting from such discount was a capital gain or regular income. It was concerned, however, with whether such gain was in fact interest. The opinion carefully examined the various factors involved and came to the conclusion that original issue discount, while in some ways like interest, differed from interest in other respects and was in fact not interest.

The writers appear to have been agreed that in the period following 1920 a taxpayer could not accrue bond discount, but had to report all of it in the year in which it was received. No part of the discount was allowed to be treated as income prorated over the life of the bond. See *Accountant's Handbook*, 2d Ed., p. 339 (1932); Newlowe, *Intermediate Accounting*, p. 205 (1939); and 4 Mertens *Law of Federal Income Taxation*, Section 23.162, p. 298. However, this well established rule does not meet the real issue in question, which is whether the income, in the year in which it was reported, was treated as a capital gain or as regular income. There is, however, one case from this period which again reiterates the fact that discount is not interest. That case is *Corn Exchange Bank* v. *Commissioner*, U. S. Board of Tax Appeals, 6 B. T. A. 158 (1927). Taxpayer had sought to amortize bond discount and premium. The Board of Tax Appeals refused to allow such amorization. In doing so, it said, at page 161:

> "The discount on the bond purchased below par is unlike interest, which is a fixed charge and accrues periodically. The right to receive this discount, or difference between the cost of the bond and its par, cannot be determined in advance as the bond may be sold for more or less than its cost, or, perhaps, as in the case of many bonds, it may be redeemed prior to [fol. 28] its maturity at an amount different from its principal or face amount of the bond. This discount is not earned or accrued in annual installments and can not be income to the holder of the bond, either as additional interest or as a separate item of income."

The Government contends that the *Corn Exchange Bank* opinion was dealing only with regular discount as distinguished from original issue discount. It fully agrees that discount which is the result of such factors as an obligor's default in interest payments does not give rise to ordinary income. However, an examination of both the fact and the opinion in the *Corn Exchange Bank* case fails to reveal that the Court there was discussing any particular kind of discount. A practical examination of the transactions involved leads the Court to conclude that it is extremely likely that both kinds of discount were involved.

This case indicates that during the 1920's the Department of Internal Revenue, which prevailed in the *Corn Exchange Bank* decision, had contended that discount was not interest. And if discount was not interest, income resulting from discount could not have been taxable at regular rates on the premise that it was interest.

In 1940 the Internal Revenue Service held that income realized from the redemption of state discount bonds was interest, and, accordingly, was non-taxible. G. C. M. 21890, 1940-1, Cum. Bul. 85. It said the courts had considered the nature of discount and found it to be like deferred interest. Such discount was, in effect, payment for the use of the money lent. The value of this ruling is questionable, however, because it necessarily involved statutory and constitutional limitations upon the federal taxation of state bonds. And while the ruling held that such discount was like interest, it carefully avoided holding that it was interest. Thus, at least until 1940, and possibly thereafter, the Internal Revenue Service held that discount was not interest. The legislative treatment of bond discount should be viewed against this administrative background.

[fol. 29] In 1929 the Congress authorized the Treasury Department to issue non-interest-bearing discount obligations. The bill authorizing these notes, as passed by the House and as approved by the Senate Finance Committee, contained a provision that, as to profits attributable to the discount, "any gain from the sale or other disposition thereof shall be exempt from all taxation." Congressional Record, Senate, June 4, 1929, p. 2319. This provision for

tax exemption met with considerable opposition upon the floor of the Senate, *because the Senators believed such profits were capital gains*, and feared that such a provision would open the way for the future exemption of all capital gains from taxation. Several members of the Senate engaged in a lengthy debate about the relationship between original issue discount and interest, and the tax consequences that flowed therefrom. That debate indicates that at least some members of the Senate believed that original issue discount was in fact a substitute for interest; but those who purported to be familiar with the subject pointed out that, under the then current practice of the Bureau of Internal Revenue, income attributable to original issue discount was treated as a capital gain and not as regular income. See page 2331, Congressional Record, supra. The question was finally resolved by the insertion of a provision in the bill that amounts received as the result of original issue discount on these notes would be called interest, thus bringing them within the already existing interest exemption. Likewise, a similar provision was added as an amendment to the Second Liberty Bond Act of 1917, Title 31 U. S. C. A., Section 757c (d). Thus, the legislative history indicates that appreciation resulting from this discount was statutorily transformed into interest to avoid its taxation as a capital gain.

These facts further substantiate the taxpayer's contention that during the period of the 1920's and early 1930's original issue discount was not considered interest, but rather gave rise to a capital gain. Furthermore, the Congress was aware of this construction and acquiesced therein by failing to statutorily change the rule until 1954. [fol. 30] See Section 1232a(2)(A), Internal Revenue Code of 1954. This section now provides that, upon the sale or exchange of evidences of indebtedness issued by a corporation or a government, amounts of appreciation attributable to original issue discount will not be considered as gains resulting from the sale or exchange of a capital asset. In other words, in 1954, and governing evidences of indebtedness issued after the ones which are now before this Court, the Congress stated that appreciation resulting from original issue discount would henceforth be considered as regular income and not as capital gain.

The House report accompanying this section stated that under existing law such gains were taxed as capital gains if the bond was held to retirement, and that this section was enacted to change the rule insofar as appreciation resulting from original issue discounts was concerned. 3 U. S. Code Congressional and Administrative News, 1954, p. 4110. The report of the Senate Finance Committee is less helpful. It merely stated that "There is some uncertainty as to the status of proceeds in these transactions, i.e., as capital gain or as interest income where the bond or other evidence of indebtedness has been issued at a discount * * *." 3 U. S. Code Congressional and Administrative News, 1954 p. 4745. In support of its statement that there was some confusion as to the current status of the law, the Senate report compared *Commissioner* v. *Caulkins* to I. T. 3486, 1941-2 Cum. Bul., p. 76. However, the Internal Revenue holding, upon which the Senate Committee relied, dealt only with a specific statutory provision which provided that such gains realized on the sale of Treasury bills should be interest. That provision had been enacted to make such gains non-taxable by bringing them within the exemption which interest enjoyed. Thus, the Senate Report does not cite any evidence of uncertainty insofar as the generally applicable principles are concerned.

At various times the Congress has enacted special provisions regarding the treatment of discount. For instance, the Internal Revenue Code of 1939, Sections [fol. 31] 201(e) and 207(e), provided that stock and mutual life insurance companies must accrue discount.

And in 1938 the House Ways and Means Committee discussed the relationship between discount and interest. That Committee report stated:

> "It is important also to emphasize that there is no clear separation, in practice, between capital gains and ordinary income; * * * *A bond purchased at a premium results in a capital loss when redeemed at par, and a bond purchased at a discount, in a capital gain.*" Hearings on H. R. 9682, Subcommittee of Committee on Ways and Means, 75th Congress, Third Session, p. 39. (Emphasis added.)

Here again is evidence of Congressional knowledge that appreciation due to bond discount was a capital gain. The Subcommittee recommended that no change be made in this rule.

Again, in Section 42(b) of the 1939 Internal Revenue Code, the Congress gave taxpayers an election to treat as current income the periodic increases in redemption value of non-interest-bearing obligations issued at a discount when such obligations were redeemable for fixed amounts which increased at stated intervals.

Thus the evidence indicates that the Congress clearly believed that appreciation resulting from original issue discount was a caiptal gain. With this knowledge Congress adopted various pieces of specific legislation providing for special treatment of discount in certain specified situations. However, Congress took no action to change the general law. These facts indicate a Congressional intention, until 1954, that capital gains treatment continue to be accorded to gains resulting from bond discount. And there was no indication of any thought that different treatment should be given to gains resulting from original issue discount than was accorded those resulting from other types of discount.

Both parties have cited various explanations and public policies underlying the special treatment which the [fol. 32] Congress has accorded to capital gains. As the Government has indicated, there are several reasons for this special treatment. However, even the Government cannot deny that one important reason is to avoid taxing, at unusually high rates, income which has in fact been earned over a number of years but which is realized only in the year of sale. In other words, the accumulation of income actually accrued ever a period of years, but realized only in the year of sale, which is inherent in the profitable sale of most capital assets, would, under our system of highly progressive income taxation, result in a taxation of such income at far higher rates than would have been the case if the income had been reportable in each of the years in which it accrued but was not realized. The capital gains provisions place a limit upon the extent to which such gains can be taxed. In view of this purpose,

it certainly appears that the long-term appreciation, resulting from original issue discount of bonds and other evidences of indebtedness, can be appropriately fitted within that category of appreciation which is accorded the special capital gains treatment.

In several instances the Tax Court has had occasion to consider the proper method of taxing gains resulting from original issue discount. It must be remembered that in the *Corn Exchange Bank* case, *supra*, the Board of Tax Appeals held that discount was not interest. The next occasion on which the Court was faced with the problem was in *Caulkins* v. *Commissioner*, 1 T. C. 656 (1943), where it decided that original issue discount gave rise to a capital gain and not to regular income. It was this opinion which was affirmed by the Sixth Circuit in *Commissioner* v. *Caulkins*, *supra*.

In 1954, on a complex factual situation, it held that discount was really interest and therefore gave rise to regular income when the securities were sold before maturity. *Paine* v. *Commissioner*, 23 T. C. 391 (1954). That holding was reversed by the Eighth Circuit in *Paine* v. *Commissioner*, 236 F. 2d 398 (1956). While it cannot be said that the Eighth Circuit held that discount resulted [fol. 33] in a capital gain, that Court did held that the appreciation involved in the *Paine* case was not interest. The language of the Court further indicates, however, that it did not think that discount created gains which were taxable as regular income.

Another case before the Court was *Commissioner* v. *Morgan*, 30 T. C. 881 (1958), involving accumulative investment certifies identical to those in the *Caulkins* case. The Tax Court held that the appreciation on these certificates was a capital gain. The Commissioner appealed that determination to the Ninth Circuit, which reversed the Tax Court. *Commissioner* v. *Morgan*, 272 F. 2d 936 (1959). The Court of Appeals considered the Sixth Circuit's *Caulkins* decision and refused to follow it. The Court held that Section 117(f) was designed only to allow capital gains treatment to be accorded to "true" capital gains. The Court refused to give the language of

Section 117 (f) the all-encompassing scope that it had been accorded by the Sixth Circuit.

The Tax Court reaffirmed its holding that such gains were capital gains in *Goodstein* v. *Commissioner*, 30 T. C. 1178 (1958). And it was again faced with another of the Caulkins-type accumulative investment certificates in *Kormendy* v. *Commissioner*, 18 T. C. M. 353 (1959). This case was decided after *Morgan* but before the reversal of *Morgan* by the Ninth Circuit. Again, the Tax Court affirmed its *Morgan* and *Caulkins* holdings.

Finally, in 1960, after the reversal of the *Morgan* decision by the Court of Appeals, the Tax Court again had a similar problem in *Stanton* v. *Commissioner*, 34 T. C. 1 (1960). In that case the taxpayer had purchased short-term Government notes and commercial paper at a discount. This paper he sold before maturity but after holding for more than six months. The excess of the amount realized over the cost was reported as a long-term capital gain. The Tax Court held that the appreciation was regular income because the notes were sold before maturity. In support of this decision the Court cited its *Paine* opinion, which it said had been reversed on other grounds.

[fol. 34] The most recent case that it has considered was *Gibbons* v. *Commissioner*, 37 T. C. No. 57. In *Gibbons* the Tax Court held that discount was *always* interest, and thus regular income, no matter whether it was realized upon a sale or exchange before retirement, or upon the retirement of a debt obligation. Thus, in *Gibbons*, the Tax Court completely rejected the *Caulkins* decision, and abandoned the distinction that it had made in *Paine* and *Stanton* between gains realized on a sale and gains realized on a retirement.

The problem of original issue discount has been considered recently by a number of constitutional courts. Most of the decisions which were cited to this Court have but again reaffirmed the validity of the general principle for which the Government contends. When the evidences of indebtedness in question were interest-bearing obligations the applicability of this proposition cannot be questioned. Cases which have dealt with the rule in such situations are: *Fisher* v. *Commissioner*, 209 F. 2d 513

(6th Circuit, 1954), cert. den. 347 U. S. 1014; *United States* v. *Langston*, 308 F. 2d 729 (5th Circuit, 1962); *Arnfeld* v. *United States*, 163 F. Supp. 865 (Court of Claims, 1958), cert. den. 359 U. S. 943; and *Jaglom* v. *Commissioner*, 303 F. 2d 847 (2nd Circuit, 1962); cf. *Commissioner* v. *Phillips*, 275 F. 2d 33 (9th Circuit, 1960). Thus, there are only five cases which actually have dealt with the treatment to be accorded to gains resulting from original issue discount. Those cases are: *Commissioner* v. *Caulkins*, 144 F. 2d 492 (6th Circuit, 1944); *Commissioner* v. *Morgan*, 272 F. 2d 936 (9th Circuit, 1959); *Rosen* v. *United States*, 288 F. 2d 658 (3rd Circuit, 1961); *United States* v. *Harrison*, 304 F. 2d 835 (5th Circuit, 1962); and *Pattiz* v. *United States*, Court of Claims No. 219-61 (1963). The *Morgan* and *Rosen* decisions were based upon the same fact situation that was presented to the Sixth Circuit in *Caulkins*. The results in the Third and Ninth Circuits were obtained by a specific rejection of the *Caulkins* decision. In neither case did the Court examine the legislative, administrative or judicial history which has surrounded the treatment [fol. 35] of original issue discount. Instead, the Court was presented with the proposition on an almost *de novo* basis and, perhaps naturally enough in the absence of familiarity with the detailed history, fell back upon the broad, general proposition for which the Government here contends. Likewise, the *Harrison* and *Pattiz* decisions were based upon a specific rejection of *Caulkins* and on an adoption of the *Morgan* and *Rosen* opinions, and neither case considered the historical treatment of original issue discount. Therefore, while it is true that the recent cases have adopted the Government's position, they have done so (1) without a discussion of the historical treatment of gains resulting from original issue discount, and (2) only upon a rejection of the *Caulkins* case, which is controlling in this Circuit.

The following factors support the taxpayer's contention: (1) the opinions of the Department of Internal Revenue and the Board of Tax Appeals, during the 1920's and early 1930's, that discount was not interest; (2) Congressional belief, expressed both in 1929 upon author-

ization of Treasury bills and later in the Second Liberty Bond Act, that original issue discount resulted in a capital gain, and consequent Congressional action to avoid that result; (3) the report of the Subcommittee of the Ways and Means Committee of the House of Representatives, in 1938, that discount gave rise to a capital gain; (4) Congressional enactment of various specific pieces of legislation providing that appreciation resulting from discount would be treated as other than a capital gain; (5) the failure of the Congress to take any action to change the treatment of bond discount except in regard to highly specialized factual situations; (6) the passage of Section 117(f), as interpreted by the *Caulkins* decision, indicating that all amounts received upon retirement, and attributable to original issue discount, were capital gains; (7) the numerous early opinions of the Tax Court that original issue discount resulted in a capital gains; and (8) the fact that none of the cases which have rejected *Caulkins* have considered the historical treatment of bond [fol. 36] discount. Against these factors, and in support of the Government's contention, it is possible to infer, from several administrative rulings dealings with specific statutory situations, that bond discount was really interest and was taxable as regular income. The 1929 Senate debate and the 1938 House hearings refute any possible implication from other Congressional enactments that original issue discount resulted in regular income. The factors supporting the taxpayer's contention are clearly of controlling weight.

It may well be that, in financial circles at least, original issue discount is considered to be a form of interest. If this is the case, it is certainly understandable why the various courts of appeal, which have considered this question on an almost *de novo* basis, have held that original issue discount resulted in regular income to the taxpayer. It is likewise true that there has been a trend—commencing with certain legislative enactments, proceeding through some administrative interpretations, and culminating with the Congressional enactment of 1954—toward classifying appreciation resulting from original issue discount as interest. This trend began with certain

very specific factual situations and expanded to include nearly all governmental and corporate evidences of indebtedness. However, careful study of this developing trend confirms the Court's belief that it has effectuated a change in the law. The facts in this case are not within any of the specific factual situations for which this change has been made and, therefore, the Court is constrained to hold that, as to the notes here in question, the appreciation for taxation purposes was not interest but, rather, an appreciation on capital, and was therefore taxable as a capital gain.

Should it be required, this memorandum will be adopted, as findings of fact and conclusions of law under Section 52(a), Federal Rules of Civil Procedure.

GIRARD E. KALBFLEISCH,
United States District Judge.

[fol. 37]

IN UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO

JUDGMENT—March 27, 1963

The Court, having considered the evidence and the arguments of counsel and having filed a memorandum opinion herein on March 11, 1963, it is in conformity therewith:

ORDERED that the plaintiff have judgment against defendant for the principal amount of $164,140.19 for the taxable year 1952 with interest thereon from June 27, 1957 at 6 percent according to law; $22,662.50 for the taxable year 1953 with interest thereon from June 27, 1957 at 6 percent according to law; and $5,660.42 for the taxable year 1954 with interest thereon from June 15, 1955 at 6 percent according to law; or a total of $192,463.11 plus interest.

DONE IN OPEN COURT at Cleveland, Ohio, this 27th day of March, 1963.

GIRARD E. KALBFLEISCH,
United States District Judge.

IN UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO

NOTICE OF APPEAL—Filed May 22, 1963

Notice is hereby given that the United States of America, the defendant in the above captioned proceeding, hereby appeals to the United States Court of Appeals for the Sixth Circuit from the Judgment entered by this Honorable Court on March 27, 1963, ordering that the plaintiff, Midland-Ross Corporation, recover from the defendant the sum of $192,463.11 plus interest.

MERLE M. MCCURDY,
United States Attorney,

By BERNARD J. STUPLINSKI,
Asst. United States Attorney.

[fol. 38]

IN THE UNITED STATE COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 15524

[File Endorsement Omitted]

MIDLAND-ROSS CORPORATION, PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

On Appeal from the United States District Court, Northern District of Ohio, Eastern Division

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OPINION—July 29, 1964

Before: WEICK, Chief Judge, CECIL, Circuit Judge, and MCALLISTER, Senior Circuit Judge.

PER CURIAM. This cause is before the Court on appeal from a judgment of the United States District Court for the Northern District of Ohio granting judgment in favor of the appellee, a taxpayer, against the United States, the appellant. The sole question presented on the appeal is whether original discount income received upon the sale of notes prior to their maturity is entitled to be treated as capital gains under Section 117(f) of the Internal Revenue Code of 1939.

Judge Kalbfleisch of the District Court wrote a comprehensive opinion in the case in which he followed the ruling of this Court in *Commissioner of Internal Revenue* v. *Caulkins*, 144 F.2d 482. While some courts [1] have taken a

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[1] *Dixon* v. *United States*, . . . F.2d . . ., C.A. 2; *Pattiz* v. *United States*, 311 F.2d 947, *Ct.Cl.*; *United States* v. *Harrison*, 304 F.2d 835, C.A. 5, cert.den., 372 U.S. 934; *Rosen* v. *United States*, 288 F.2d 658, C.A. 3; *Commissioner* v. *Morgan*, 272 F.2d 936, C.A. 9.

contrary view on the issue presented we are of the opinion that the *Caulkins* case, controlling in our circuit, was correctly decided.

[fol. 39] The pertinent facts are stated in the opinion of the District Court reported at *Midland-Ross Corp.* v. *United States*, 214 F.Supp. 631. We agree with the opinion of Judge Kalbfleisch and the judgment of the District Court is affirmed.

[fol. 40]

IN THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

JUDGMENT—Filed July 29, 1964

Appeal from the United States District Court for the Northern District of Ohio.

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Ohio, and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby affirmed.

No costs awarded. Rule 23(4).

Approved for entry:
/s/ Lester L. Cecil
United States Circuit Judge

[fol. 41]

[Clerk's Certificate to foregoing transcript omitted in printing]

[fol. 42]

SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1964

No. 628

UNITED STATES, PETITIONER

v.

MIDLAND-ROSS CORPORATION

ORDER ALLOWING CERTIORARI—December 14, 1964

The petition herein for a writ of certiorari to the United States Court of Appeals for the Sixth Circuit is granted, and the case is placed on the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1965 760028 511

In the Supreme Court of the United States

OCTOBER TERM, 1964

No. ——

UNITED STATES OF AMERICA, PETITIONER

v.

MIDLAND-ROSS CORPORATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Solicitor General, on behalf of the United States, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit in the above-entitled case.

OPINIONS BELOW

The opinion of the district court (R. 20a–36a)[1] is reported at 214 F. Supp. 631. The opinion of the court of appeals (App. 7–8) is reported at 335 F. 2d 561.

JURISDICTION

The judgment of the court of appeals was entered on July 29, 1964 (App. 8). The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

[1] "R." refers to the appendix to the government's brief in the court of appeals; "App." to the appendix to this petition.

748-108—64

QUESTION PRESENTED

Whether the excess of the face amount of a note over the amount of money for which it was issued represents interest, making the portion of the proceeds of the lender's subsequent sale of the note which is attributable to the excess taxable as ordinary income rather than as capital gain.

STATUTES INVOLVED

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived * * * from interest, * * * or gains or profits and income derived from any source whatever. * * *

*　*　*　*　*

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

*　*　*　*　*

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months * * *.

STATEMENT

At various times during 1952, 1953, and 1954, respondent advanced large sums of money to financial institutions in exchange for notes of those institutions. The notes, 13 in number, were usually in the face amount of $1,000,000 or $2,000,000, and in each case were payable in less than a year's time. The notes did not in terms provide for interest, but the amount advanced in exchange for the notes was determined by dis-

counting the face amount at a rate agreed upon by the parties (usually between 2% and 2.5% on an annual basis). In each instance, respondent sold the note to a bank a few days before its maturity (R. 15a–18a). A typical transaction, as described in the stipulation, was the following (R. 16a, ¶12):

> On January 29, 1952, [respondent] paid $1,955,416.67 to the Commercial Investment Trust Company and received in return therefor a note of the Commercial Investment Trust Company in the face amount of $2,000,000, payable to the bearer on December 15, 1952. Said note was not in registered form and contained no provision for the payment of interest. On December 4, 1952, [respondent] sold said note to the Union Bank of Commerce for a price of $1,998,166.67, resulting in a gain to [respondent] of $42,750.

Respondent's total gain on the sale of the 13 notes was $282,763. It reported the gain on its income tax returns for the three years as capital gain. The Commissioner determined that the excess of the face amount of the notes over the amount of money for which they were issued represented interest. Since the notes were all sold in the same taxable year in which they were acquired, and since the gain was attributable entirely to the maturing of the notes and the discount at which they were issued, he treated the entire gain realized on the sale of the notes as ordinary income in the nature of interest. Respondent paid the resulting deficiencies in income and excess profits taxes and in due course brought this suit for refund. The district court held the gains taxable

only as capital gain (R. 20a–36a) and entered judgment for respondent in the amount of $192,463 plus interest from the date of overpayment (R. 37a). The court of appeals affirmed, in a brief *per curiam* opinion (App. 7–8).

REASONS FOR GRANTING THE WRIT

The basic question in this case—whether original-issue discount must be accounted for as interest—is identical to that in *Dixon* v. *United States*, No. 486, this Term, in which the taxpayer has filed a petition for certiorari based upon the acknowledged conflict between the decision of the Second Circuit in that case and that of the Sixth Circuit in this case. The notes and transactions involved in the two cases are substantially identical, the only difference between the cases being in the basis upon which the deficiencies were determined. In *Dixon*, the taxpayer was required to accrue the interest earned during the year even on notes that were not sold in that year. In this case, all the notes were sold in the year acquired, and the Commissioner determined the deficiency by simply treating the gain on the sale of the notes as ordinary income—in effect, since it made no significant difference, treating the taxpayer as though it were on the cash basis.[2] Even if the difference in the accounting

[2] Had the taxpayer—in fact on the accrual basis—been required to accrue the "interest" earned during its period of holding, the deficiencies would have been slightly greater, but only by an almost infinitesimal amount. The difference in result was too slight to warrant the additional interest computations that would have been required by a strict application of accrual accounting.

theories on which the deficiencies were determined be thought significant, however, that would still not eliminate the conflict. For the decision below would remain in conflict with the following cases, each of which also involved the treatment of the proceeds from a sale or redemption of a note issued at a discount: *Real Estate Investment Trust of America* v. *Commissioner*, 334 F. 2d 986 (C.A. 1); *Rosen* v. *United States*, 288 F. 2d 658 (C.A. 3); *United States* v. *Harrison*, 304 F. 2d 835 (C.A. 5), certiorari denied, 372 U.S. 934;[3] *Pattiz* v. *United States*, 311 F. 2d 947 (Ct. Cls.).

We are simultaneously filing a response acquiescing in the petition for certiorari in the *Dixon* case. For the reasons there stated, the petition in this case should also be granted so that both accounting treatments will be before the Court at the same time. The records in both cases are so simple, and the notes and transactions involved are so identical, that we do not believe that the burden on the Court will be significantly increased by having two cases rather than one before it. Alternatively, if the Court agrees that the difference in accounting treatment does not affect the issue, it may prefer merely to postpone action on this

[3] *Commissioner* v. *Morgan*, 272 F. 2d 936 (C.A. 9), although also expressing disagreement with the Sixth Circuit, involved an accrual-basis taxpayer who, as in *Dixon*, was required to report the original-issue discount ratably as it accrued.

petition until the final disposition of the *Dixon* case.

Respectfully submitted.

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OCTOBER 1964.

APPENDIX

No. 15524

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MIDLAND-ROSS CORPORATION, PLAINTIFF-APPELLEE

v.

UNITED STATES OF AMERICA, DEFENDANT-APPELLANT

On Appeal from the United States District Court, Northern District of Ohio, Eastern Division

Decided July 29, 1964

Before: WEICK, Chief Judge, CECIL, Circuit Judge, and MCALLISTER, Senior Circuit Judge.

PER CURIAM. This cause is before the Court on appeal from a judgment of the United States District Court for the Northern District of Ohio granting judgment in favor of the appellee, a taxpayer, against the United States, the appellant. The sole question presented on the appeal is whether original discount income received upon the sale of notes prior to their maturity is entitled to be treated as capital gains under Section 117(f) of the Internal Revenue Code of 1939.

Judge Kalbfleisch of the District Court wrote a comprehensive opinion in the case in which he followed the ruling of this Court in *Commissioner of Internal Revenue* v. *Caulkins,* 144 F. 2d 482. While

some courts [1] have taken a contrary view on the issue presented we are of the opinion that the *Caulkins* case, controlling in our circuit, was correctly decided.

The pertinent facts are stated in the opinion of the District Court reported at *Midland-Ross Corp.* v. *United States*, 214 F. Supp. 631. We agree with the opinion of Judge Kalbfleisch and the judgment of the District Court is affirmed.

JUDGMENT

(Filed July 29, 1964)

Appeal from the United States District Court for the Northern District of Ohio.

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Ohio, and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby affirmed.

No costs awarded. Rule 23(4).

Approved for entry:

s/ LESTER L. CECIL,
United States Circuit Judge.

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[1] *Dixon* v. *United States*, — F. 2d —, C.A. 2; *Pattiz* v. *United States*, 311 F. 2d 947, Ct. Cl.; *United States* v. *Harrison*, 304 F. 2d. 835, C.A. 5, cert. den., 372 U.S. 934; *Rosen* v. *United States*, 288 F. 2d 658, C.A. 3; *Commissioner* v. *Morgan*, 272 F. 2d 936, C.A. 9.

U.S. GOVERNMENT PRINTING OFFICE: 1964

In the Supreme Court of the United States

No. 628.

OCTOBER TERM, 1964.

UNITED STATES OF AMERICA,
Petitioner,

vs.

MIDLAND-ROSS CORPORATION,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

BRIEF FOR RESPONDENT IN OPPOSITION.

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In the Supreme Court of the United States

No. 628.

OCTOBER TERM, 1964.

UNITED STATES OF AMERICA,
Petitioner,

vs.

MIDLAND-ROSS CORPORATION,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals For the Sixth Circuit.

BRIEF FOR RESPONDENT IN OPPOSITION.

OPINIONS BELOW.

The opinion of the United States District Court for the Northern District of Ohio (R. 20a-36a),[1] is reported at 214 F. Supp. 631 and is reproduced in the Appendix to this Response. The opinion of the Court of Appeals is reported at 335 F. 2d 561.

JURISDICTION.

The jurisdictional requisites are adequately set forth in the Petition for Writ of Certiorari.

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[1] R. refers to the Appendix to the Government's brief in the Court of Appeals.

QUESTION PRESENTED.

Is there sufficient continuing importance in the matter to justify this Court's intervening to review decisions on whether, under the law as it existed prior to 1954, the increase in value of a debt obligation issued at less than face value should be taxed as if it were interest?

STATEMENT.

Respondent is the successor by merger to Industrial Rayon Corporation (Industrial) (Stip. par. 2, R. p. 14a). During 1952, 1953 and 1954 Industrial, following a long practice (Stip. par. 26, R. p. 19a), used its excess funds to acquire various non-interest bearing corporate notes of the type commonly used for financing by General Motors Acceptance Corporation, Commercial Investment Trust Co. and Commercial Credit Co. at less than their face value (i.e., at a discount) (Stip. par. 11-20, R. pp. 15a-18a). Each of the notes were sold prior to maturity at a profit which aggregated $282,763 (Stip. par. 11-20, R. pp. 15a-18a). Industrial reported this profit as capital gain, partly long-term and partly short-term (Stip. par. 27, R. p. 20a). The Internal Revenue Service asserted a deficiency on the ground that the profit should be taxed as if it were interest. Industrial paid the applicable tax and instituted this action for its refund.

There is no contention that the discount at which the notes were purchased was, as a factual matter, interest in disguise. On the contrary, it is stipulated that there was no interest (Stip. par. 11-20, R. pp. 15a-18a) and that Industrial realized gains from the sale of capital assets (Stip. par. 23, R. p. 19a).

Under the law which has been in effect since December 31, 1954, the profit would be taxed as ordinary income.[2]

---

[2] Section 1232 (a) (2), Internal Revenue Code of 1954.

However, the transactions involved here occurred prior to the change in the law, so that respondent contends, and the lower court held, that the profit should be taxed as capital gain.

ARGUMENT.

A. THE ISSUE IS NOT OF CONTINUING IMPORTANCE.

The Government contends that even though the law involved here was changed ten years ago, the question presented is still important (Government's Br. p. 8).[3] This is in direct conflict with the Government's position only one year ago in its brief in opposition to a petition for certiorari in *Harrison v. United States*, 304 Fed. 2d 835 (5th Cir. 1962), cert. denied 372 U. S. 934:

> "Moreover, the question here in dispute is of rapidly diminishing importance, for Section 1232(a)(2) of the 1954 Code (*supra*, pp. 3-4) expressly provides that as to bonds issued after December 31, 1954 any gain realized by a bond holder attributable to original issue discount is taxable as ordinary income. Compare Valley Morris Plan v. Commissioner, No. 447 October Term 1962, certiorari denied, 371 U. S. 922." (Brief in Op., No. 681, 1962 Term pp. 7-8.)

Nevertheless, the Government now argues that there are three separate reasons for the continuing importance of the identical question.

First, although it admits that the pending cases on this issue are relatively few in number, the Government says it has "no solid basis" to dispute the claim made by petitioners in *Dixon v. United States* "that there may be some such obligations [issued prior to 1955] still outstanding"

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[3] All references to the Government's Brief are to the brief filed in *Dixon v. United States*, No. 486, 1964 Term, which the Government treats throughout as applicable to the present case as well.

(Government's Br. p. 8) and that there are open transactions. For this Court to grant certiorari merely on the basis of the Government's assertion that it has no solid evidence that the issue is not important would be extraordinary. Furthermore, examination of readily available material clearly indicates that any remaining problems in this area cannot be substantial.

Since the type of obligation involved here and in *Dixon v. United States, supra,* is not issued with more than a twelve month maturity, all issued before 1955 were retired nine years ago. Under the circumstances, it is highly unlikely that there are open controversies concerning them.

As to types of obligations not directly involved, an examination of Standard & Poor's recent bond guide[4] covering approximately 3,000 outstanding bond issues reveals that there are now only two issues of domestic bonds[5] reported which were originally issued at a discount sufficient to be taxed under Section 1232,[6] neither of which would necessarily be governed by a decision here.[7]

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[4] Standard & Poor's *Earnings and Ratings Bond Guide* (Standard & Poor's Corp., Oct. 1964).

[5] In addition the Guide lists eight such foreign issues, all now in default, as to which only questions clearly different in nature from that presented here could arise since the discount in all probability was attributable in large measure to the uncertainties of deferred payment in foreign currency. There are further listed two foreign perpetual bonds issued at discounts as to which no annual discount rate can be computed and which would therefore also involve a different point.

[6] The statute only affects discounts in excess of 1/4 of 1% per year. Section 1232 (b) (1) Internal Revenue Code of 1954.

[7] One of these bonds has traded as high as 99½ (Cincinnati, Indianapolis and Western R.R. 5% First Mortgage Bonds issued in 1922 due 1965) raising the question of the amount to be taxed to an intermediate purchaser who bought at such a price. The other issue (The Cleveland, Chicago and St. Louis R.R., Cincin-

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The outstanding bonds of these two issues were originally sold in 1916 and 1922 at discounts aggregating one and one-half million dollars, but of this only about $250,000 remains to be realized.[8] While there may be other bonds not listed in the Standard & Poor's Guide which would still be affected by the old law, the very small percentage of such bonds in the Guide indicates that any remaining problem is not substantial.

Second, while Section 1232 does not apply to obligations issued by individuals, there is no reported case involving such an individual obligation. If such a case should ever arise, that will be time enough to decide whether it merits the attention of this Court.

Third, the Government argues that Section 1232 does not answer whether discount must be accrued from day to day as if it were interest, or if it should be taxed in the year of the sale or redemption of the obligation involved (Government's Br., pp. 9-10). This asserted problem can, at most, affect the year in which the income is taxed, not the amount of income. Further, the statute explicitly requires that the gain "be considered as gain from the

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nati, Wabash and Michigan Division 4% First Mortgage Bonds of 1916 due 1990) have not traded as high as their issue price for many years and therefore involve the different question of the realization of discount income where there is no increase in value with the passage of time. Furthermore, similar problems, not presented in the cases before the court, undoubtedly exist with respect to discount bonds possibly not listed in Standard & Poor's, so that the number of situations which would be affected by a decision here is most likely only a small fraction of whatever pre-1955 bonds may be outstanding.

[8] The amount of discount subject to possible controversy undoubtedly lies between these two figures. As to purchasers of the original issue, the full discount could be involved. As to intermediate purchasers, varying amounts may be involved, depending on the time of purchase and the price.

sale or exchange of property which is not a capital asset."[9] Detailed rules have been developed for the reporting of such gain[10] which in many respects differ from the rules for reporting interest.[11] Assuming *arguendo* that a decision here would affect the interpretation of Section 1232, a characterization of discount as "interest" would simply create confusion as to which set of detailed rules should govern under present law.

All indications are that the question involved here is simply one of historical interest. There are even fewer cases than the Government indicates, since some of those listed involve patently different issues;[12] the amounts involved are not great and the questions remaining under Section 1232 are insignificant. At most, the Government simply speculates that problems remain.

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[9] Section 1232 (a) (2) (A) Internal Revenue Code of 1954.

[10] These rules are set forth at length in 2 Mertens *Law of Federal Income Taxation*, §§ 12.118 & 12.121-12.126, Esp. §§ 12.125 & 12.126.

[11] See 2 Mertens *Law of Federal Income Taxation*, §§ 12.47 & 12.95.

[12] Of the three cases so cited (Government's Br. 8-9, n. 6) counsel for the taxpayers report that *Meyer v. Commissioner*, T. C. Docket No. 1198-63 involves post-1955 documents, some of which have already been held in *Sherwood Memorial Gardens, Inc.*, 42 T. C. 211 (1964) to be stock rather than debt, which have no principal amount, and which entitle the holder simply to a share of the proceeds of sale of cemetery lots; *May v. Commissioner*, T. C. Docket No. 67,659 involves principally the question whether a genuine indebtedness existed although approximately 2½% of the alleged deficiency involves an issue similar to that presented here.

B. THE DECISION BELOW IS CORRECT.

1. The Government's disarmingly simple formulation significantly distorts the real nature of the problem involved.

The Government reduces the merits of this case to a comparison between a $100 note bearing 6% interest and a $106 non-interest bearing note issued for $100 (Government's Br. p. 4), citing *Deputy v. DuPont* for the proposition that "Interest is 'merely compensation for the use of forebearance of money.' "[13] (Government's Br. p. 5.) This deceptively simple illustration ignores the real nature of the problem involved. There is no doubt that interest (which is "compensation for the use of money") is taxed as ordinary income. It is equally true, however, that courts have long recognized that certain types of "compensation for the use of money" result in capital gain. The problem is where under the old law the line should be drawn to distinguish among variations in commercial practice. All had agreed, prior to 1953,[14] that the line had been drawn so as to treat discount as a capital item.

One common example of compensation for the use of money accorded capital gain treatment arises upon the sale of a capital asset for a deferred purchase price greater than the price that would be charged in a cash sale. Here there is plainly a gain to the seller due entirely to the use of the seller's money by the purchaser. Yet it is clear that prior to the 1964 Revenue Act the entire purchase price

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[13] In the *DuPont* case itself, the phrase had been used to contrast compensation for use of *common stock*. *Deputy v. DuPont,* 308 U. S. 488, 498.

[14] In 1953 the Revenue Service first publicly reversed its long-standing position that discount was a capital item. Rev. Rul. 119, 1953-2 Cum. Bull. 95. This change in position is analyzed in Janin, *The Israeli Bond Ruling: Legislation by Administrative Fiat?*, 33 Taxes 191 (1955).

was taxed as capital gain. See *Paine v. Commissioner*, 236 F. 2d 398 (8th Cir. 1956); *Kingsford Co. v. Commissioner*, 41 T. C. No. 64 (1964). Similarly the increase in the value of a lease during an initial period when rents are not due is treated as capital in nature. *Josey v. Commissioner*, 104 F. 2d 453 (10th Cir. 1939). On the Government's theory that all compensation for the use of money is interest, indeed, Section 224 of the 1964 Revenue Act, which imputes a quantum of interest to certain deferred payment sales which do not on their face bear interest, was a wholly superfluous enactment.[15]

Nor is it necessary to refer to prior case law to establish that the equation of discount with interest wholly fails to take into account commonplace commercial realities. Discount, for example, can be attributable primarily to the fact that an obligation is to be repayable in foreign currency [16] yet it would make no economic sense at all to tax all or any part of such a discount as ordinary income. And of course it is conceded that gain attributable to market discount does not result in ordinary income for tax purposes, so that if a bond is issued at 100 and later declines to 90, the 10 point gain on maturity of a purchaser at 90 is accorded capital gain treatment.

Moreover, decisions of this Court dealing with the tax treatment of bond premiums flatly refute the Government's equation of sums paid as "compensation for the use

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[15] Other instances in which compensation for the use of money has not resulted in interest income treatment are to be found in the ruling involving discount for prepayment of insurance premiums at a 3% per annum compound rate, I. T. 3513, 1941-2 Cum. Bull. 75, and the decision of the Fourth Circuit in *Baltimore & Ohio R. R. Co. v. Commissioner*, 78 F. 2d 460 (4th Cir. 1935) involving discount at the rate of 6% per annum for prepayment of the purchase price for stock.

[16] The problem of repayment in foreign currency is far from a hypothetical one. See note 5, *supra*.

or forebearance of money" with interest income. Bond premium, of course, is identical in principle to discount. Premium is simply the amount by which the price exceeds face value, while discount is the amount by which the price falls short of face value. This Court first rejected any principle of taxation based on an artificially constructed "effective rate of interest" in *New York Life Ins. Co. v. Edwards,* 271 U. S. 109, when it held that bond premiums could not be amortized in ord o allow the taxpayer to be taxed on less than the actual interest it received. And in *Old Colony R. R. v. Commissioner,* 284 U. S. 552, this Court stated the very argument advanced by the Government here:

> The conclusion is that the actual return to one who pays a premium is less than the nominal interest carried by the bond, and to one who buys at a discount is greater than such nominal rate. The argument is that although the regulations are inaptly phrased and are susceptible of the construction petitioner places upon them their real intent was to adjust the nominal interest paid on a corporation's indebtedness to the actual amount it is paying for the use of the money represented by the par of the bond,—that is, to what accountants have called the 'effective rate' of interest. 284 U. S. at 558-559.

only to reject it decisively:

> We cannot believe that Congress used the word having in mind any concept other than the usual, ordinary and everyday meaning of the term, or that it was acquainted with the accountants' phrase 'effective rate' of interest and intended that as the measure of the permitted deduction.[17] 284 U. S. at 561.

[17] In 1942 legislation was enacted to permit an offset of bond premium against interest received. Section 125, Internal Revenue Code of 1939. Bond premium may now be amortized in ac-

(Continued on following page)

2. The most directly relevant authorities have not been considered by other Courts.

While the Sixth Circuit reached a result contrary to that arrived at by several other courts, it cannot be overemphasized that the decision below is the only one which analyzed the real problem involved, and (perhaps as a consequence) is the only one which so much as mentioned *any* of the legal materials which should be determinative.[18] In describing the two earliest opinions that had reached a different result, the District Court, in its opinion which was adopted by the Sixth Circuit, noted:

> In neither case did the Court examine the legislative, administrative or judicial history which has surrounded the treatment of original issue discount. Instead, the Court was presented with the proposition on an almost *de novo* basis and, perhaps naturally enough in the absence of familiarity with the detailed history, fell back upon the broad, general proposition for which the Government here contends. R. pp. 34a-35a.[19]

(Continued from preceding page)

cordance with the statutory election, but unless the election is made it is still considered a capital item. 4 Mertens, *Law of Federal Income Taxation*, §§ 23.162, 23.167.

In *Commissioner v. Korell*, 339 U. S. 619, holding that a premium paid for a conversion privilege was amortizable, this Court rejected the Treasury's argument that the adjustment permitted by Section 125 should be allowed only to the extent that it achieved an "effective interest rate." And in *Hanover Bank v. Commissioner*, 369 U. S. 672, this Court, holding that bond premium amortization could be based on a special call price which probably would not be used, once again definitely rejected the Government's plea that amortization be permitted only on the basis of an "effective rate of interest."

[18] Undoubtedly this was for the most part because these materials were not presented to the courts. *Compare e.g.*, the limited use of materials in the Petition for Certiorari in *Harrison v. United States*, cert. denied, 372 U. S. 934 (No. 681, 1962 Term) *with* the District Court's decision below.

[19] The reference is to *Commissioner v. Morgan*, 272 F. 2d 936 (9th Cir. 1959) and *Rosen v. United States*, 288 F. 2d 658 (3rd Cir. 1961).

The court went on to point out that the other two differing opinions were based largely on an adoption of the two earlier decisions, and again:

> neither case considered the historical treatment of original issue discount. R. p. 35a.[20]

Indeed, even the Sixth Circuit in its earlier decision in *Commissioner v. Caulkins,* 144 F. 2d 482 (6th Cir. 1944), while it reached the correct result, did so without the benefit of this material.[21]

While it is not our purpose to argue the merits of the case on the certiorari proceedings, it is necessary to point out the extent of the materials which do not seem to have been considered by any Circuit other than the Sixth.

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[20] The reference is to *United States v. Harrison,* 304 F. 2d 835 (5th Cir. 1962) cert. denied 372 U. S. 934 and *Pattiz v. United States,* 311 F. 2d 947 (Ct. Cl. 1963). While the District Court's opinion in the instant case was issued prior to the decisions of the First and Second Circuits in *Real Estate Investment Trust of America v. United States,* No. 620, 1964 Term, and *Dixon v. United States, supra,* no Circuit Court at the time of those decisions had considered the material which the Sixth Circuit found controlling and neither the First nor Second Circuits referred to any of this material. The Second Circuit, moreover, in a situation where the commercial circumstances underlying the transaction differed from those presented in *Dixon,* has recently indicated its rejection of the sweeping formulation on which the Government bases its case in this Court, by reaching a result consonant with that arrived at by the Sixth Circuit. *Lubin & Eisner v. Commissioner,* not yet reported, 64-2 USTC par. 9666 (2nd Cir. 1964).

[21] The Sixth Circuit in the *Caulkins* case was cited to largely irrelevant legislative history concerning the issuance of non-interest bearing Treasury Bonds, the discount on which is by statute equated with interest. The original enactment was in 1929 (presently § 754 (b) of Title 31 U. S. C.) and the legislative history of this enactment shows clearly that Congress understood discount in the absence of such a statute to be a capital item. See nn. 23-24, *infra.* Subsequently, in 1935, a similar provision was enacted (presently § 757c (d) of Title 31 U. S. C.) as to which there is virtually no legislative history. The Sixth Circuit in the *Caulkins* case was referred only to the latter enactment.

First, in contrast to the report of the Senate Finance Committee cited in the *Dixon* case, the House Ways and Means Committee, in connection with the enactment of Section 1232, stated:

> (E) Bonds and other debt (sec. 1232).
>
> Under existing law any gain realized from a corporate or Government bond in registered form or with coupons attached *is treated as a capital gain either if the bond is held to retirement or if it is sold or exchanged.* Part or all of the gain, however, may represent discount on original issue which is a form of interest income and in fact is deductible as an interest payment by the issuing corporation.
>
> *Effective with respect to bonds issued after December 31, 1954,* the committee bill provides that any gain realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income. * * * 3 U. S. Code Congressional and Administrative News 1954, p. 4110. (Emphasis added.)

Other major areas of legislative history, which have been considered only by the Court below, include the representation of the Under Secretary of the Treasury to the Senate Finance Committee in 1929 that the increment in commercial paper issued at a discount (apparently of the very type involved here) was capital gain;[22] a Senate debate in 1929, indicating that the Senate so understood the law;[23] and a recommendation by a subcommittee of

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[22] A statement of Senator Couzens indicates that the Under Secretary of the Treasury, Ogden Mills, so reported to the Senate Finance Committee at an executive session. 71 Cong. Rec. 2329 (June 4, 1929).

[23] 71 Cong. Rec. 2319-2333 (June 4, 1929) where Senator Reed said:

> Mr. President, it seems to me that these questions have brought the issue down to the real point. What actually happens in the case of the transaction described by the Senator from Montana is that a negotiable instrument [a discount

(Continued on following page)

the Ways & Means Committee of the House of Representatives that there be no change in the law which taxed the increment arising from purchase at a discount as capital gain.[24] Congress, moreover, was active throughout the pre-1954 period at issue here, and the numerous legislative enactments governing the tax treatment of both bond discount and bond premium[25] are wholly inconsistent with a Congressional purpose to change *sub silentio* the treatment of bond discount as a capital item; a treatment which Congress must have assumed in enacting these specifically defined legislative exceptions to the recognized general rule. When Congress did act on the precise question here at issue, in 1954, it acted explicitly and, more significantly, its enactment was explicitly prospective.

In addition to this legislative history, thoroughly analyzed in the District Court's opinion reproduced in the

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(Continued from preceding page)

obligation] is bought at one price, and subsequently sold at another; and the profit, taken in connection with the time the bill is held, *is a capital gain* which is the equivalent of interest on the money. (Emphasis added.) 71 Cong. Rec. 2331 (June 4, 1929).

[24] *Report of Subcommittee of Committee on Ways and Means,* dated January 1, 1938, reported in *Hearings on H. R. 9682,* 75th Cong. 3rd Sess. p. 38.

[25] Section 117 (a) (1) (D), Internal Revenue Code of 1939, excluding from the definition of capital assets short term discount obligations without interest issued by governmental units; Section 201 (e), Internal Revenue Code of 1939, requiring amortization of both discount and premium on all obligations but only for life insurance companies; Section 207 (d), Internal Revenue Code of 1939, requiring amortization of discount and premium on all obligations but only for mutual insurance companies; Section 42 (b), Internal Revenue Code of 1939, allowing an election to taxpayers to report increases in the value of discount obligations annually; Section 42 (c), Internal Revenue Code of 1939, providing that income from short term government discount obligations should not be taken into account until disposition of the obligations; Section 125, Internal Revenue Code of 1939,, providing an election to amortize premium; Section 113 (b) (1) (H), Internal Revenue Code of 1939, providing a reduction in basis for amortized bond premium.

Appendix, interpretations by the Internal Revenue Service and its predecessors, until 1953, consistently treated the entire increment to a discount obligation as capital gain.[26] In fact, this position, directly contrary to that urged here, was taken as recently as one year prior to the Government's 1953 change of position in an informal ruling holding that the gain from the very type of commercial paper involved here was capital gain.[27] Published rulings to the same effect had been issued previously,[28] and the Government had successfully litigated this position.[29]

The Government relies on cases holding that the debtor corporation can deduct discount over the life of the bonds. (Government's Br. p. 5). There are indeed cases which speak of this deduction as "interest,"[30] but the weight of authority is clearly that the deduction is allowed as a loss[31]—a capital item. In fact, the very case cited by

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[26] The Revenue Service in fact acquiesced in *Caulkins* from 1944 to 1955, Acq. 1944 Cum. Bull. 5, non-acq. 1955-1 Cum. Bull. 7, albeit with reservations from 1953. See Rev. Rul. 119, 1953-2 Cum. Bull. 95.

[27] 5 CCH 1952, Stand. Fed. Tax Rep. par. 6161. This ruling uses the typical style of numerous cross-references so that its meaning is not clear without reference to § 211 (a) (1) (B), Internal Revenue Code of 1939 (dealing with capital gains of aliens) and to the request for the ruling published at 5 CCH 1952, Stand. Fed. Tax Rep. par. 6284.

[28] O. 1024, 2 Cum. Bull. 189 (1920); O. D. 475, 2 Cum. Bull. 211 (1920); I. T. 1398, I-2 Cum. Bull. 149 (1922).

[29] *Corn Exchange Bank v. Commissioner*, 6 B. T. A. 159 (1927). The lack of litigation during the period between this case and the Treasury's change of position further emphasizes the point.

[30] *e.g., Western Maryland Ry. Co. v. Commissioner*, 33 F. 2d 695 (4th Cir. 1929).

[31] 2 Mertens *Law of Federal Income Taxation*, § 12.109, ch. 12, p. 345 states: "Bond discount is founded upon the concept of compensation for a prospective loss"; Molloy, *The Ambiguous Tax Nature of the Various Costs of Borrowing Capital*, 11 Tax Law Review 373, 399-400 (1956), concludes that the weight of authority is that the deduction is allowed as a loss.

the Government for the proposition that the deduction is allowed as interest proceeds primarily on the contrary theory that the deduction is allowed as a loss.[32] This Court stated in that case:

> It is a loss to the taxpayer, definite as to its date and amount, and represents a part of the cost of the borrowed capital during each year of the life of the bond issue. 293 U. S., at 287.

Thus, under the law as it existed in 1944, the Sixth Circuit in *Caulkins* did not need to rely on the extensive materials available because it was generally agreed at that time that discount was a capital item.[33] For instance, the Government attorney in the *Caulkins* case conceded in the Tax Court proceedings that, in the absence of a special statutory exception, the increment on United States Savings Bonds would be capital gain. 1 T. C. 656, 662 (1943). In this setting, only a few years after a subcommittee of Congress had recommended that no change be made in the law taxing discount as capital gain,[34] no extensive authority was necessary for the Sixth Circuit to reach the correct result. Courts which later rejected *Caulkins,* moreover, relied primarily on cases such as *United States v. Snow,* 223 Fed. 2d 103 (9th Cir., 1955) cert. denied 350 U. S. 831, and the Sixth Circuit's own decision in *Fisher v. Commissioner,* 209 Fed. 2d 513 (6th Cir., 1954) cert.

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[32] *Helvering v. Union Pacific Co.,* 293 U. S. 282. Actually the Court was concerned throughout with commissions on the sale of bonds, but the governing principles are the same as those applicable to discount.

[33] Text writers were unanimously in accord. See 4 Mertens *Law of Federal Income Taxation,* § 23.162 n. 31; Newlove, *Intermediate Accounting* 205 (1939 ed.); Paton, *Advanced Accounting* 196 (1941); *Accountants' Handbook* 339 (2d ed. 1939); Lawrence, *Bond Discount Treatment Under the 1942 Revenue Act,* 21 Taxes 651 (1943).

[34] See note 24 *supra.*

denied 347 U. S. 1014, which stated the well-established principle that the sale of a right to ordinary income constitutes an assignment of income and results in ordinary income. Reliance only on this principle is, however, inevitably wide of the mark, for such reliance assumes the very point at issue, i.e., whether, prior to 1954, the increment in value of an admittedly capital asset (e.g., a bond or note), due to its purchase at a discount (for bargain price), was properly characterizable as an item of ordinary income rather than capital gain. Yet an examination of the pre-1954, and therefore governing, law is precisely what the cases contrary to *Caulkins*, all decided after Section 1232 had been enacted, neglected to undertake.

The authorities outlined above, which only the Sixth Circuit has passed on, all bear directly upon the question of the nature of the pre-1954 law on the narrow issue presented by this case. And the *Caulkins* decision, which is all that was passed on by the courts reaching a different result, did not itself, for the reasons indicated above, contain a consideration of those materials. Thus, in the last analysis, the Government's case for the grant of a writ of certiorari must stand or fall solely on the basis of an academic conflict in result, itself based on authority which failed to examine the directly relevant materials. The Government offers no defensible ground to justify granting the writ; it cannot and will not cite any judicial authority prior to 1953 to the effect that corporation bond discount is ordinary income; nor can it even cite any instance prior to 1953 where the administrative position was that such discount gain should be taxed as if it were interest.

Perhaps, were the narrow issue presented by this case of more than historical interest, this Court's intervention to resolve even such a conflict might be justified. A similar conclusion with regard to the petitions for the writ in the

cases now before the Court seems untenable, however, in light of the diminishing importance of the issue, and the fact that only one Circuit has passed upon the relevant legislative and judicial authority.

CONCLUSION.

For the reasons stated, respondent respectfully submits that the writ should be denied.[35]

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[35] Since there is technically no conflict in the treatment of an accrual taxpayer, if certiorari is granted in only one case, it should be granted here where the conflict is, rather than only in *Dixon v. United States*. See Government's Br. pp. 6-7.

APPENDIX.

MEMORANDUM OF THE DISTRICT COURT ON TAX TREATMENT OF ORIGINAL ISSUE DISCOUNT.

(Filed March 11, 1963.)

KALBFLEISCH, J.

This is a suit to recover income and excess profits taxes for the years 1952, 1953 and 1954. The taxpayer is the Midland-Ross Corporation, successor in interest to the Industrial Rayon Corporation. During the period in question, for the purpose of temporarily investing funds not then currently required for its operation, the taxpayer purchased thirteen notes, the face amounts of which varied from $500,000 to $2,000,000. These notes bore no interest, but rather were purchased at a discount by the taxpayer from the maker. Each of the notes was a time instrument. Before maturity each note was sold to a financial institution at a price which was in excess of the price which had been paid to the maker but below the face amount.

The price paid by the taxpayer to the maker of each note was calculated by subtracting from the face amount a figure determined by multiplying the face amount by an agreed percentage, dividing the product by 360, and multiplying the result by the number of days from the date of such payment to the maturity of the note. The agreed percentage was determined on the basis of the consideration of several factors, including (1) the prevailing interest rates for notes of such duration made by borrowers with credit standings of the obligor, (2) the availability of such notes to prospective purchasers, and (3) the maker's need for cash funds. All of the notes were capital assets in the hands of the taxpayer and were sold by it in bona fide sales. In negotiating the sale price of the notes, the following factors were considered: (1) the face

amounts of the obligations, (2) the credit rating of the obligor, (3) the period of time between the sale and the maturity of the notes, (4) the prevailing interest rates, and (5) the amount of cash funds available to the purchaser.

In this three-year period the taxpayer realized a total appreciation of more than $280,000 on these notes. It contended that this appreciation was a capital gain, while the Internal Revenue Service contended that it was regular income. The taxpayer paid taxes at the regular income rate, and is here seeking a refund.

The relevant sections of the Internal Revenue Code are: Section 117(a) (1) (2) and (4) and Section 111(a) of the 1939 Code, and their counterparts in the Code of 1954.

Section 117(a) (1) of the 1939 Code defines a capital asset as:

> "* * * property held by the taxpayer (whether or not connected with his trade or business), but does not include * * *
>
> (D) an obligation of the United States or of any of its possessions, or of a state or territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue."

Subsections (2) and (4) of Section 117(a) provide that a capital gain is a gain from the sale of a capital asset, and Section 111(a) provides that the gain from the disposition of property is the "excess of the amount realized therefrom over the adjusted basis * * *."

Plaintiff stresses the fact that the language of the statute, especially of Section 117(a) (1) defining a capital

asset, is broad and sweeping. It contends that because these notes were capital assets the gain realized thereon was a capital gain. It contends, further, that in view of Section 117(a) (1) (D), which specifically excludes certain types of discount paper from the category of capital assets, and in view of the failure to exclude such paper as these notes, the Congress clearly indicated its intention that the gain achieved on the sale of such notes constitutes capital gain under the maxim of *expressio unius est exclusio alterius.*

The taxpayer's contention is a familiar enough general rule of statutory construction. However, various courts have read certain exceptions into this statute. They have held that, while it might appear that a literal construction of the statutory language would convert all but the specifically excluded gains into capital gains, the provisions must be construed in the light of their general purpose and the surrounding law. After so doing, these courts have read further exceptions into the statute, which have resulted in the exclusion from capital gains treatment of certain increments which a literal interpretation might indicate were capital gains. See, for example, *Jaglom v. Commissioner,* 303 F. 2d 847 (2nd Cir., 1962); *United States v. Harrison,* 304 F. 2d 835 (5th Cir., 1962). In view of the fact that these statutory sections have not been interpreted to include all of the transactions which the sweeping scope of their language might indicate were within their purview, the Court is constrained to hold that this argument is not dispositive of the case.

The Government contends that the realized increment was in fact interest paid for the use of money, and was therefore regular income to the taxpayer. It contends that this is but another instance for application of the well recognized rule that when a taxpayer combines the sale

of a right to receive ordinary income with the sale of a capital asset the ordinary income is not converted into a capital gain by its sale in combination with the capital asset. *Fisher v. Commissioner*, 209 F. 2d 513 (6th Cir., 1954), cert. den. 347 U. S. 1014; *Commissioner v. Morgan*, 272 F. 2d 936 (9th Cir., 1959); *Rosen v. United States*, 288 F. 2d 658 (3rd Cir., 1961); *United States v. Harrison*, 304 F. 2d 835 (5th Cir., 1962); and *United States v. Langston*, 308 F. 2d 729 (5th Cir., 1962).

The taxpayer does not dispute the general validity of this proposition. Its principal contention, however, is that the rule is inapplicable on these facts because the increment, for purposes of taxation at least, was not interest. It fully admits that if these notes had borne interest at a stated rate, and if it had then sold such notes before maturity at an increase in price, the amount of such increase allocable to the proportion of the interest earned to the date of sale would have been regular income under the rule of *Fisher v. Commissioner* and the other cases cited, *supra*. However, it contends that a different result is achieved when, instead of the notes bearing interest at a fixed rate, they were originally sold at a discount. The taxpayer urges that there has been a continuous history of legislative, administrative and judicial interpretation since 1920 which has consistently held that original issue discount in the hands of a cash basis taxpayer is not income, and that the appreciation resulting therefrom is not taxed as regular income but, rather, as a capital gain.

If it is true that historically the law has not considered such original issue discount as interest, but has removed it from the broad category of regular income and placed it within the specific classification of capital gain, then the increment in this case was not income and the general rule upon which the Government relies is inapplicable.

The Court, therefore, must proceed to examine the treatment which such discount has traditionally received.

Commissioner v. Caulkins, 144 F. 2d 482 (6th Cir., 1944) is the primary cornerstone upon which the taxpayer rests its contention that the increment here involved was not, for taxation purposes at least, compensation for the use of its money. In that case the taxpayer had purchased an accumulative installment certificate under the terms of which he was to make periodic payments to the seller, who, at the end of ten years, would pay to the taxpayer the sum of $20,000. This $20,000 was approximately $4,900 more than the total amount of the payments made to the seller. The Commissioner contended that this $4,900 was compensation for the use of the taxpayer's money, and was thus really interest. He held that this interest was regular income, although the taxpayer contended it was a capital gain.

The certificate involved in the *Caulkins* case was in registered form and the decision was based upon an interpretation of Section 117(f) of the Internal Revenue Code of 1939. Section 117(f) provided that amounts received by the holder of registered securities upon their retirement should be considered as amounts received in exchange therefor. The Court held that, although the $4,900, at least in many respects, was similar to interest, it was an amount which was received in exchange for the sale of a capital asset and was therefore a capital gain.

To understand the *Caulkins* decision it is necessary to understand the history of Section 117(f). Before the enactment of that section it had been held that retirement of a bond was not such a sale or exchange as would qualify the amount received upon the retirement for capital gains treatment. See *Fairbanks v. United States*, 306 U. S. 436 (1939). Section 117(f) was enacted to avoid

this holding. It provided that amounts received upon the retirement of certain evidences of indebtedness which had interest coupons attached, or which were in registered form, should be considered as amounts received in exchange therefor. This provision enabled the amounts received upon the retirement of such bonds to qualify as capital gains. The taxpayer contends that this provision was enacted to accord the same tax treatment to such bonds upon their retirement as always had been accorded them on a sale before retirement. And, according to *Mertens Law of Federal Income Tax,* Volume 38, [*sic*] [Vol. 3B] page 368, M 82 [*sic*] [n. 82]:

> "The purpose underlying the enactment of Section 117(f) of the 1939 Code was to accord to the retirement of obligations similar treatment as was then, and is now, accorded to their sale or exchange."

In view of the purpose of Section 117(f), it appears that before the passage of that section amounts received upon the sale of such evidences of indebtedness did qualify for capital gains treatment. If a sale before maturity of such obligations did not permit increments to be accorded capital gains treatment, it is unlikely that the Congress would have deliberately enacted a provision according them such favorable treatment upon retirement.

From the combination of this legislative history with the *Caulkins* decision it is possible to draw the following analogy: Section 117(f), under the *Caulkins* holding, provided that all amounts received in exchange for the retirement of a qualifying capital asset were capital gains. Because Section 117(f) was meant to be declaratory of the pre-existing law on sales before retirement, it follows that all amounts received on the pre-retirement sale of such debt obligations were likewise capital gains. The

validity of this analogy must be tested by a further inquiry into legislative, administrative and judicial history. However, before proceeding with that history it is necessary to examine the Government's position as to what the *Caulkins* case really held.

The Government contends that *Caulkins* was based solely upon an interpretation of Section 117(f). It says that the crucial fact in *Caulkins* was not that the debt obligations were discount obligations but that a retirement rather than a sale was involved. It has thus attempted to convince the Court that the *Caulkins* decision does not control this case, because in the present instance the notes were sold before maturity, rather than retired. It is true that the opinion in the *Caulkins* case primarily discusses the retirement factor; however, the Court is not convinced that increments on debt obligations which qualify under Section 117(f) would be accorded capital gains treatment if the obligations were retired, but would be taxed at regular income rates if they were sold before maturity. Even the Tax Court, which adopted that position in *Paine v. Commissioner,* 23 T.C. 391 (1954), Rev. 236 F. 2d 398 (8th Cir., 1956), and *Stanton v. Commissioner,* 34 T.C. 1 (1960), has now abandoned such a distinction. *Gibbons v. Commissioner,* 37 T.C. No. 57. The purpose of Section 117(f) surely was not to accord a more favorable tax treatment to income realized upon retirement of debt obligations than it would receive if they were sold before maturity. The quotation from *Mertens, supra,* also clearly indicates that such was not the case. Therefore, this Court is constrained to hold that the crucial fact in the *Caulkins* case was that the evidences of indebtedness were discount obligations.

The combination of the *Caulkins* case with Section 117(f) thus indicates that appreciation realized on evi-

dences of indebtedness, issued at an original discount and sold before maturity, constituted a capital gain and not regular income. The remaining question, therefore, is whether the legislative, administrative and judicial treatments of discount obligations support this indication.

The earliest administrative decision upon this matter which has been furnished to the Court is Office Decision 1024 published in Vol. 2, Cum. Bul. 189 (1920), holding that original issue discount on bonds was not interest and, therefore, was not subject to special withholding provisions when the bonds were in the hands of foreign corporations. It is true, as the Government contends, that this opinion was not concerned with whether an appreciation resulting from such discount was a capital gain or regular income. It was concerned, however, with whether such gain was in fact interest. The opinion carefully examined the various factors involved and came to the conclusion that original issue discount, while in some ways like interest, differed from interest in other respects and was in fact not interest.

The writers appear to have been agreed that in the period following 1920 a taxpayer could not accrue bond discount, but had to report all of it in the year in which it was received. No part of the discount was allowed to be treated as income prorated over the life of the bond. See *Accountant's Handbook,* 2d Ed., p. 339 (1932); Newlowe, *Intermediate Accounting,* p. 205 (1939); and 4 Mertens *Law of Federal Income Taxation,* Section 23.162, p. 298. However, this well established rule does not meet the real issue in question, which is whether the income, in the year in which it was reported, was treated as a capital gain or as regular income. There is, however, one case from this period which again reiterates the fact that discount is not interest. That case is *Corn Exchange Bank v. Commis-*

sioner, U. S. Board of Tax Appeals, 6 B. T. A. 158 (1927). Taxpayer had sought to amortize bond discount and premium. The Board of Tax Appeals refused to allow such amortization. In doing so, it said, at page 161:

> "The discount on the bond purchased below par is unlike interest, which is a fixed charge and accrues periodically. The right to receive this discount, or difference between the cost of the bond and its par, cannot be determined in advance as the bond may be sold for more or less than its cost, or, perhaps, as in the case of many bonds, it may be redeemed prior to its maturity at an amount different from its principal or face amount of the bond. This discount is not earned or accrued in annual installments and can not be income to the holder of the bond, either as additional interest or as a separate item of income."

The Government contends that the *Corn Exchange Bank* opinion was dealing only with regular discount as distinguished from original issue discount. It fully agrees that discount which is the result of such factors as an obligor's default in interest payments does not give rise to ordinary income. However, an examination of both the fact and the opinion in the *Corn Exchange Bank* case fails to reveal that the Court there was discussing any particular kind of discount. A practical examination of the transaction involved leads the Court to conclude that it is extremely likely that both kinds of discount were involved.

This case indicates that during the 1920's the Department of Internal Revenue, which prevailed in the *Corn Exchange Bank* decision, had contended that discount was not interest. And if discount was not interest, income resulting from discount could not have been taxable at regular rates on the premise that it was interest.

In 1940 the Internal Revenue Service held that income realized from the redemption of state discount bonds was interest, and, accordingly, was non-taxable. G. C. M. 21890, 1940-1, Cum. Bul. 85. It said the courts had considered the nature of discount and found it to be like deferred interest. Such discount was, in effect, payment for the use of the money lent. The value of this ruling is questionable, however, because it necessarily involved statutory and constitutional limitations upon the federal taxation of state bonds. And while the ruling held that such discount was like interest, it carefully avoided holding that it was interest. Thus, at least until 1940, and possibly thereafter, the Internal Revenue Service held that discount was not interest. The legislative treatment of bond discount should be viewed against this administrative background.

In 1929 the Congress authorized the Treasury Department to issue non-interest-bearing discount obligations. The bill authorizing these notes, as passed by the House and as approved by the Senate Finance Committee, contained a provision that, as to profits attributable to the discount, "any gain from the sale or other disposition thereof shall be exempt from all taxation." Congressional Record, Senate, June 4, 1929, p. 2319. This provision for tax exemption met with considerable opposition upon the floor of the Senate, *because the Senators believed such profits were capital gains,* and feared that such a provision would open the way for the future exemption of all capital gains from taxation. Several members of the Senate engaged in a lengthy debate about the relationship between original issue discount and interest, and the tax consequences that flowed therefrom. That debate indicates that at least some members of the Senate believed that original issue discount was in fact a substitute for

interest; but those who purported to be familiar with the subject pointed out that, under the then current practice of the Bureau of Internal Revenue, income attributable to original issue discount was treated as a capital gain and not as regular income. See page 2331, Congressional Record, *supra*. The question was finally resolved by the insertion of a provision in the bill that amounts received as the result of original issue discount on these notes would be called interest, thus bringing them within the already existing interest exemption. Likewise, a similar provision was added as an amendment to the Second Liberty Bond Act of 1917, Title 31 U. S. C. A., Section 757c (d). Thus, the legislative history indicates that appreciation resulting from this discount was statutorily transformed into interest to avoid its taxation as a capital gain.

These facts further substantiate the taxpayer's contention that during the period of the 1920's and early 1930's original issue discount was not considered interest, but rather gave rise to a capital gain. Furthermore, the Congress was aware of this construction and acquiesced therein by failing to statutorily change the rule until 1954. See Section 1232a(2) (A), Internal Revenue Code of 1954. This section now provides that, upon the sale or exchange of evidences of indebtedness issued by a corporation or a government, amounts of apppreciation atttributable to original issue discount will not be considered as gains resulting from the sale or exchange of a capital asset. In other words, in 1954, and governing evidences of indebtedness issued after the ones which are now before this Court, the Congress stated that appreciation resulting from original issue discount would henceforth be considered as regular income and not as capital gain.

The House report accompanying this section stated that under existing law such gains were taxed as capital

gains if the bond was held to retirement, and that this section was enacted to change the rule insofar as appreciation resulting from original issue discounts was concerned. 3 U. S. Code Congressional and Administrative News, 1954, p. 4110. The report of the Senate Finance Committee is less helpful. It merely stated that "There is some uncertainty as to the status of proceeds in these transactions, i.e., as capital gain or as interest income where the bond or other evidence of indebtedness has been issued at a discount * * *." 3 U. S. Code Congressional and Administrative News, 1954, p. 4745. In support of its statement that there was some confusion as to the current status of the law, the Senate report compared *Commissioner v. Caulkins* to I. T. 3486, 1941-2 Cum. Bul., p. 76. However, the Internal Revenue holding, upon which the Senate Committee relied, dealt only with a specific statutory provision which provided that such gains realized on the sale of Treasury bills should be interest. That provision had been enacted to make such gains non-taxable by bringing them within the exemption which interest enjoyed. Thus, the Senate Report does not cite any evidence of uncertainty insofar as the generally applicable principles are concerned.

At various times the Congress has enacted special provisions regarding the treatment of discount. For instance, the Internal Revenue Code of 1939, Sections 201(e) and 207(e), provided that stock and mutual life insurance companies must accrue discount.

And in 1938 the House Ways and Means Committee discussed the relationship between discount and interest. That Committee report stated:

> "It is important also to emphasize that there is no clear separation, in practice, between capital gains and ordinary income; * * * *A bond purchased at a pre-*

> *mium results in a capital loss when redeemed at par, and a bond purchased at a discount, in a capital gain.*" Hearings on H. R. 9682, Subcommittee of Committee on Ways and Means, 75th Congress, Third Session, p. 39. (Emphasis added.)

Here again is evidence of Congressional knowledge that appreciation due to bond discount was a capital gain. The Subcommittee recommended that no change be made in this rule.

Again, in Section 42(b) of the 1939 Internal Revenue Code, the Congress gave taxpayers an election to treat as current income the periodic increases in redemption value of non-interest-bearing obligations issued at a discount when such obligations were redeemable for fixed amounts which increased at stated intervals.

Thus the evidence indicates that the Congress clearly believed that appreciation resulting from original issue discount was a capital gain. With this knowledge Congress adopted various pieces of specific legislation providing for special treatment of discount in certain specified situations. However, Congress took no action to change the general law. These facts indicate a Congressional intention, until 1954, that capital gains treatment continue to be accorded to gains resulting from bond discount. And there was no indication of any thought that different treatment should be given to gains resulting from original issue discount than was accorded those resulting from other types of discount.

Both parties have cited various explanations and public policies underlying the special treatment which the Congress has accorded to capital gains. As the Government has indicated, there are several reasons for this special treatment. However, even the Government cannot deny that one important reason is to avoid taxing, at

unusually high rates, income which has in fact been earned over a number of years but which is realized only in the year of sale. In other words, the accumulation of income actually accrued ever a period of years, but realized only in the year of sale, which is inherent in the profitable sale of most capital assets, would, under our system of highly progressive income taxation, result in a taxation of such income at far higher rates than would have been the case if the income had been reportable in each of the years in which it accrued but was not realized. The capital gains provisions place a limit upon the extent to which such gains can be taxed. In view of this purpose, it certainly appears that the long-term appreciation, resulting from original issue discount of bonds and other evidences of indebtedness, can be appropriately fitted within that category of appreciation which is accorded the special capital gains treatment.

In several instances the Tax Court has had occasion to consider the proper method of taxing gains resulting from original issue discount. It must be remembered that in the *Corn Exchange Bank* case, *supra*, the Board of Tax Appeals held that discount was not interest. The next occasion on which the Court was faced with the problem was in *Caulkins v. Commissioner*, 1 T. C. 656 (1943), where it decided that original issue discount gave rise to a capital gain and not to regular income. It was this opinion which was affirmed by the Sixth Circuit in *Commissioner v. Caulkins*, *supra*.

In 1954, on a complex factual situation, it held that discount was really interest and therefore gave rise to regular income when the securities were sold before maturity. *Paine v. Commissioner*, 23 T. C. 391 (1954). That holding was reversed by the Eighth Circuit in *Paine v. Commissioner*, 236 F. 2d 398 (1956). While it cannot be

said that the Eighth Circuit held that discount resulted in a capital gain, that Court did hold that the appreciation involved in the *Paine* case was not interest. The language of the Court further indicates, however, that it did not think that discount created gains which were taxable as regular income.

Another case before the Court was *Commissioner v. Morgan*, 30 T. C. 881 (1958), involving accumulative investment certificates identical to those in the *Caulkins* case. The Tax Court held that the appreciation on these certificates was a capital gain. The Commissioner appealed that determination to the Ninth Circuit, which reversed the Tax Court. *Commissioner v. Morgan*, 272 F. 2d 936 (1959). The Court of Appeals considered the Sixth Circuit's *Caulkins* decision and refused to follow it. The Court held that Section 117(f) was designed only to allow capital gains treatment to be accorded to "true" capital gains. The Court refused to give the language of Section 117(f) the all-encompassing scope that it had been accorded by the Sixth Circuit.

The Tax Court reaffirmed its holding that such gains were capital gains in *Goodstein v. Commissioner*, 30 T. C. 1178 (1958). And it was again faced with another of the Caulkins-type accumulative investment certificates in *Kormendy v. Commissioner*, 18 T. C. M. 353 (1959). This case was decided after *Morgan* but before the reversal of *Morgan* by the Ninth Circuit. Again, the Tax Court affirmed its *Morgan* and *Caulkins* holdings.

Finally, in 1960, after the reversal of the *Morgan* decision by the Court of Appeals, the Tax Court again had a similar problem in *Stanton v. Commissioner*, 34 T. C. 1 (1960). In that case the taxpayer had purchased short-term Government notes and commercial paper at a dis-

count. This paper he sold before maturity but after holding for more than six months. The excess of the amount realized over the cost was reported as a long-term capital gain. The Tax Court held that the appreciation was regular income because the notes were sold before maturity. In support of this decision the Court cited its *Paine* opinion, which it said had been reversed on other grounds.

The most recent case that it has considered was *Gibbons v. Commissioner,* 37 T. C. No. 57. In *Gibbons* the Tax Court held that discount was *always* interest, and thus regular income, no matter whether it was realized upon a sale or exchange before retirement, or upon the retirement of a debt obligation. Thus, in *Gibbons,* the Tax Court completely rejected the *Caulkins* decision, and abandoned the distinction that it had made in *Paine* and *Stanton* between gains realized on a sale and gains realized on a retirement.

The problem of original issue discount has been considered recently by a number of constitutional courts. Most of the decisions which were cited to this Court have but again reaffirmed the validity of the general principle for which the Government contends. When the evidences of indebtedness in question were interest-bearing obligations the applicability of this proposition cannot be questioned. Cases which have dealt with the rule in such situations are: *Fisher v. Commissioner,* 209 F. 2d 513 (6th Circuit, 1954), cert. den. 347 U. S. 1014; *United States v. Langston,* 308 F. 2d 729 (5th Circuit, 1962); *Arnfeld v. United States,* 163 F. Supp. 865 (Court of Claims, 1958), cert. den. 359 U. S. 943; and *Jaglom v. Commissioner,* 303 F. 2d 847 (2nd Circuit, 1962); cf. *Commissioner v. Phillips,* 275 F. 2d 33 (9th Circuit, 1960). Thus, there are only five cases which actually have dealt with the treatment to be accorded to gains resulting from original

issue discount. Those cases are: *Commissioner v. Caulkins*, 144 F. 2d 492 (6th Circuit, 1944); *Commissioner v. Morgan*, 272 F. 2d 936 (9th Circuit, 1959); *Rosen v. United States*, 288 F. 2d 658 (3rd Circuit, 1961); *United States v. Harrison*, 304 F. 2d 835 (5th Circuit, 1962); and *Pattiz v. United States*, Court of Claims No. 219-61 (1963). The *Morgan* and *Rosen* decisions were based upon the same fact situation that was presented to the Sixth Circuit in *Caulkins*. The results in the Third and Ninth Circuits were obtained by a specific rejection of the *Caulkins* decision. In neither case did the Court examine the legislative, administrative or judicial history which has surrounded the treatment of original issue discount. Instead, the Court was presented with the proposition on an almost *de novo* basis and, perhaps naturally enough in the absence of familiarity with the detailed history, fell back upon the broad, general proposition for which the Government here contends. Likewise, the *Harrison* and *Pattiz* decisions were based upon a specific rejection of *Caulkins* and on an adoption of the *Morgan* and *Rosen* opinions, and neither case considered the historical treatment of original issue discount. Therefore, while it is true that the recent cases have adopted the Government's position, they have done so (1) without a discussion of the historical treatment of gains resulting from original issue discount, and (2) only upon a rejection of the *Caulkins* case, which is controlling in this Circuit.

The following factors support the taxpayer's contention: (1) the opinions of the Department of Internal Revenue and the Board of Tax Appeals, during the 1920's and early 1930's, that discount was not interest; (2) Congressional belief, expressed both in 1929 upon authorization of Treasury bills and later in the Second Liberty Bond Act, that original issue discount resulted in a capital

gain, and consequent Congressional action to avoid that result; (3) the report of the Subcommittee of the Ways and Means Committee of the House of Representatives, in 1938, that discount gave rise to a capital gain; (4) Congressional enactment of various specific pieces of legislation providing that appreciation resulting from discount would be treated as other than a capital gain; (5) the failure of the Congress to take any action to change the treatment of bond discount except in regard to highly specialized factual situations; (6) the passage of Section 117(f), as interpreted by the *Caulkins* decision, indicating that all amounts received upon retirement, and attributable to original issue discount, were capital gains; (7) the numerous early opinions of the Tax Court that original issue discount resulted in a capital gains; and (8) the fact that none of the cases which have rejected *Caulkins* have considered the historical treatment of bond discount. Against these factors, and in support of the Government's contention, it is possible to infer, from several administrative rulings dealing with specific statutory situations, that bond discount was really interest and was taxable as regular income. The 1929 Senate debate and the 1938 House hearings refute any possible implication from other Congressional enactments that original issue discount resulted in regular income. The factors supporting the taxpayer's contention are clearly of controlling weight.

It may well be that, in financial circles at least, original issue discount is considered to be a form of interest. If this is the case, it is certainly understandable why the various courts of appeal, which have considered this question on an almost *de novo* basis, have held that original issue discount resulted in regular income to the taxpayer. It is likewise true that there has been a trend—commencing with certain legislative enactments, proceeding

through some administrative interpretations, and culminating with the Congressional enactment of 1954—toward classifying appreciation resulting from original issue discount as interest. This trend began with certain very specific factual situations and expanded to include nearly all governmental and corporate evidences of indebtedness. However, careful study of this developing trend confirms the Court's belief that it has effectuated a change in the law. The facts in this case are not within any of the specific factual situations for which this change has been made and, therefore, the Court is constrained to hold that, as to the notes here in question, the appreciation for taxation purposes was not interest but, rather, an appreciation on capital, and was therefore taxable as a capital gain.

Should it be required, this memorandum will be adopted as findings of fact and conclusions of law under Section 52(a), Federal Rules of Civil Procedure.

GIRARD E. KALBFLEISCH,
United States District Judge.

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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 628

UNITED STATES OF AMERICA, PETITIONER

v.

MIDLAND-ROSS CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court (R. 18–33) is reported at 214 F. Supp. 631. The opinion of the court of appeals (R. 35–36) is reported at 335 F. 2d 561.

JURISDICTION

The judgment of the court of appeals was entered on July 29, 1964 (R. 36). The petition for writ of certiorari was filed on October 26, 1964, and was granted on December 14, 1964 (R. 37). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the excess of the face amount of a note over the amount of money for which it was issued represents interest, making that portion of the proceeds of the lender's subsequent sale of the note which is attributable to the excess taxable as ordinary income rather than as capital gain.

STATUTES INVOLVED

The relevant statutes and regulations are set out in the Appendix, pp. 47–53, *infra*.

STATEMENT

At various times during 1952, 1953, and 1954, respondent advanced large sums of money to financial institutions in exchange for notes of those institutions. The notes, 13 in number, were usually in the face amount of $1,000,000 or $2,000,000 and in each case were payable in less than a year. The notes did not in terms provide for interest, but the amount advanced in exchange for the notes was determined by discounting the face amount at a rate agreed upon by the parties (usually between 2% and 2.5% on an annual basis). In each instance, respondent sold the note to a bank a few days before its maturity (R. 12–16). A typical transaction, as described in the stipulation, was the following (R. 13):

> On January 29, 1952, [respondent] paid $1,955,416.67 to the Commercial Investment Trust Company and received in return therefor a note of the Commercial Investment Trust Company in the face amount of $2,000,000, payable to the

> bearer on December 15, 1952. Said note was not in registered form and contained no provision for the payment of interest. On December 4, 1952, [respondent] sold said note to the Union Bank of Commerce for price of $1,998,166.67, resulting in a gain to [respondent] of $42,750.

Respondent's total gain on the sale of the 13 notes was $282,763. It reported the gain on its income tax returns for the 3 years as capital gain. The Commissioner determined that the excess of the face amount of the notes over the amount of money for which they were issued represented interest. Since the notes were all sold in the same taxable year in which they were acquired, and since the gain was attributable entirely to the maturing of the notes and the discount at which they were issued, he treated the entire gain realized on the sale of the notes as ordinary income in the nature of interest (R. 17). Respondent paid the resulting deficiencies in income and excess profits taxes and in due course brought this suit for refund (R. 12). The district court held the gains taxable only as capital gain (R. 18–33) and entered judgment for respondent in the amount of $192,463 plus interest from the date of overpayment (R. 34). The court of appeals affirmed in a brief *per curiam* opinion (R. 35–36).

SUMMARY OF ARGUMENT

If *A* gives *B* $100 for a note promising to pay in one year, $100 plus 6% interest, and if *A* sells the note eight months later for $104, it is conceded that

$4 of the proceeds of the sale, being attributable to the interest earned up to the date of the sale, would be taxable to *A* as ordinary income. The only question in this case is whether, under the 1939 Code, it makes a difference if the note promises to pay, not "$100 plus 6% interest," but simply "$106." The court below held that it does and that, if the note is cast in the latter form, the $4 gain is taxable only as capital gain. The First, Second, Third, Fifth and Ninth Circuits, the Court of Claims, and the Tax Court, disagreeing with the Sixth Circuit, all hold that the $4 is taxable as ordinary income in either case.

The expressions "$100 plus 6% interest for one year" and "$106" mean exactly the same thing; they are as identical as are the expressions "2 times 2" and "4". In either case, the borrower agrees to pay an additional $6 to the lender at the end of the year as compensation for the use of the $100 borrowed. Interest being but "compensation for the use or forebearance of money" (*Deputy* v. *DuPont,* 308 U.S. 488, 498), the $6 is interest in either case, and the maturing right to receive the promised amount is thus a maturing right to ordinary income the proceeds of the sale of which must be taxed as ordinary income.

Nor does the historical treatment of "original-issue discount," as the district court thought, require so illogical a distinction to be made. The earlier decision of the Sixth Circuit on which the court relied was based, not on a distinction between original-issue discount and stated interest, but on a reading of § 117(f)

of the 1939 Code as specifically directing that capital gains treatment be given to *all* amounts realized on retirement of debt obligations regardless of whether any part was interest (as the court acknowledged it in fact was). The ground of that decision has long since been repudiated, and it cannot now be read as establishing a distinction between the two forms of interest which the court itself denied.

The identity of original-issue discount and interest has long been recognized in every context in which the character of an item as "interest" is important. Under regulations in force since 1918 and the uniform decisions of both this Court and the lower courts, it is established that, to the borrower, the excess of the amount of money he must repay on maturity over the amount borrowed is but a cost of the use of borrowed money which, if he is on the accrual basis, he may accrue and deduct annually. Similarly, original-issue discount has long been treated as interest for purposes of the statutory exclusion of "interest" from State and municipal bonds. While there was initially some doubt how the exemption applied to amounts received from third parties, since 1932 it has been established that the portion of the proceeds of a sale of a State bond attributable to the discount at which the bond was issued is itself "interest" within the meaning of the exemption. Again, it has been established at least since 1925 that an accrual-basis lender who lends money on a discount basis (*e.g.*, a bank which loans $100 in exchange for the borrower's note in the amount of $106) must

accrue as income the portion of the discount earned each year. Finally, in 1941 Congress, regarding it as settled under existing law that the proceeds of a sale of an obligation issued at a discount must be allocated between the portion attributable to the discount (taxable as ordinary income) and the portion attributable to the underlying asset (accounted for as capital gain or loss), adopted special provisions to relieve holders of short-term government obligations of the burden of making such allocations—in circumstances in which they had little effect—and instead made the entire gain on disposition taxable as ordinary income.

Far from requiring that a distinction be made between logically indistinguishable things, the history thus shows that original-issue discount has for decades been regarded as but interest in another form—not only by the government but by Congress and the courts as well. The proceeds of a sale attributable to original-issue discount, like the proceeds attributable to stated interest, must therefore be taxed as ordinary income.

ARGUMENT

Introduction

On January 29, 1952, respondent paid $1,955,416 to the Commercial Investment Trust Company ("C.I.T.") in exchange for a note from C.I.T. promising to repay $2,000,000 (*i.e.,* the $1,955,416 borrowed plus an additional amount of $44,584) 321 days later. Eleven days before the note was due, respondent sold

the note to a bank for $1,998,166, thereby realizing a gain of $42,750. The question is whether the portion of the sale proceeds attributable to the almost fully accrued right to the additional $44,584 C.I.T. had agreed to pay in exchange for the use of the money—in effect, the $42,750 gain [1]—is to be taxed as ordinary income (the proceeds of a sale of a right to ordinary income) or as capital gain (the proceeds of a sale of a capital asset).

There is no dispute that the $42,750 would be taxable as ordinary income if the C.I.T. note had in form promised to pay, not the amount borrowed plus $44,584, but rather the amount borrowed "plus 2.6% interest." As the district court noted, respondent "fully admits that if these notes had borne interest at a stated rate, and if it had then sold such notes before maturity at an increase in price, the amount of such increase allocable to the proportion of the interest earned to the date of sale would have been regular income" (R. 20). The district court, whose opinion was in effect adopted by the court of appeals,

[1] The portion of the proceeds attributable to the accrued compensation is not technically the same thing as the "gain" on the sale, but on the facts of this case the difference was insignificant and was therefore ignored in determining the deficiencies.

In addition, since respondent is in fact an accrual-basis taxpayer, the transactions technically should have been accounted for on accrual principles. Since the notes were all sold in the same year they were acquired, however, the deficiencies were determined simply on the basis of the proceeds of the sales—in effect, because it was simpler and made no significant difference, treating respondent as though it were on the cash basis.

also agreed that that proposition "cannot be questioned" (R. 30), and it is in any event fully and firmly established by the decisions both of the court below and of other courts.[2] It is equally unchallenged that an accrual-basis taxpayer holding such a note beyond the end of his taxable year would have to accrue and report as income the interest earned on the note during the year.[3] The sole question, therefore, is whether it makes a difference for tax purposes whether the *quid pro quo* promised to be paid in exchange for the use of money is stated in the note as a percentage rate of "interest" or is stated as a part of a fixed sum of money not otherwise characterized.

The court below held that it makes all the difference and that the proceeds of a sale of a right to be paid a fixed sum as compensation for a loan of money is taxable only as capital gain, notwithstanding that the proceeds of a sale of a right to be paid the same amount, expressed as a rate of "interest," would be taxed as ordinary income. The First, Second, Third, Fifth, and Ninth Circuits, the Court of Claims, and the Tax Court, on the other hand, expressly reject the distinction and hold that the proceeds are taxable

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[2] *Jaglom* v. *Commissioner*, 303 F. 2d 847 (C.A. 2); *Fisher* v. *Commissioner*, 209 F. 2d 513 (C.A. 6), certiorari denied, 347 U.S. 1014; *United States* v. *Langston*, 308 F. 2d 729 (C.A. 5); *First Kentucky Co.* v. *Gray*, 309 F. 2d 845 (C.A. 6); *Arnfeld* v. *United States*, 163 F. Supp. 865 (Ct. Cls.); cf. *Commissioner* v. *Phillips*, 275 F. 2d 33 (C.A. 4).

[3] See *Commissioner* v. *Morgan*, 272 F. 2d 936 (C.A. 9); *Dixon* v. *United States*, 333 F. 2d 1016 (C.A. 2), pending on certiorari, No. 486; *Oregon Pulp & Paper Co.* v. *Commissioner*, 34 T.C. 624; cf. Treas. Regs. 118, § 39.117(a)-1(d).

as ordinary income in either case.[4] For the future, the question has been largely resolved by § 1232 of the Internal Revenue Code of 1954, which expressly provides that any gain on the sale of corporate or governmental obligations issued at a discount will be treated as ordinary income to the extent of the original-issue discount. Because of the limitations on the scope of § 1232, however, the question of the proper treatment of such notes under the prior law remains of continuing importance.[5] Accordingly, to resolve the admitted conflict between the Sixth Circuit and the other courts as to the proper result under the 1939 Code, we acquiesced in the taxpayer's petition for certiorari in the companion case (*Dixon* v. *United States*, No. 486) and filed a petition on behalf of the United States in this case.

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[4] *Real Estate Investment Trust of America* v. *Commissioner*, 334 F. 2d 986 (C.A. 1), pending on petition for certiorari (No. 620); *Dixon* v. *United States*, 333 F. 2d 1016 (C.A. 2), pending on certiorari (No. 486); *Rosen* v. *United States*, 288 F. 2d 658 (C.A. 3); *United States* v. *Harrison*, 304 F. 2d 835 (C.A. 5), certiorari denied, 372 U.S. 934; *Commissioner* v. *Morgan*, 272 F. 2d 936 (C.A. 9); *Pattiz* v. *United States*, 311 F. 2d 947 (Ct. Cl.); *Schwartz* v. *Commissioner*, 40 T.C. 191. See also *Leavin* v. *Commissioner*, 37 T.C. 766; *Gibbons* v. *Commissioner*, 37 T.C. 569; *Nesler* v. *United States* (N.D. Iowa), decided December 19, 1963 (13 A.F.T.R. 2d 588); *Oglansky* v. *Commissioner*, decided January 23, 1963 (P-H Tax Ct. Mem. Dec., ¶ 63,018).

[5] Section 1232 does not apply to obligations issued before 1955 or to any obligations of individuals, nor does it in terms prescribe how original-issue discount should be treated under the accrual method of accounting. See our brief in response to the petition for certiorari in *Dixon* v. *United States*, No. 486, pp. 8–10.

We will first show that the distinction made by the court below is indefensible in principle and could not be sustained even if it were of long standing. We will then show, contrary to the assertion of the court below, that the recent decisions of the other courts uniformly rejecting its view, far from effecting an abrupt "change" in the law, are fully supported by the historical treatment of original-issue discount.

I

AN AMOUNT AGREED TO BE PAID BY A BORROWER TO A LENDER IN EXCHANGE FOR THE USE OF MONEY IS INTEREST FOR TAX PURPOSES REGARDLESS OF WHETHER IT IS STATED AS AN ABSOLUTE AMOUNT OF MONEY OR AS A PERCENTAGE RATE OF "INTEREST"

1. The decision below rests upon a difference of words having no substantive consequences. If *A* agrees to lend *B* $100 for a year and *B* in exchange agrees to pay *A* $6 extra at the end of the year, there are perhaps five basic variations in the wording that might be used to express *B's* obligation in a note. The note might provide that on the due date *B* will pay *A*:

(1) $100 plus 6% interest;
(2) $100 plus 6%;
(3) $100 plus $6 interest;
(4) $100 plus $6; or
(5) $106.

If *A* should sell the note for $104 after holding it for 8 months, the court below would hold that the $4 gain was ordinary income if the first form of expression

was used[8] but capital gain if the last form was used. What it would hold in the intermediate cases is less certain, since it is unclear precisely what it regards as the key to the different treatment: use of the word "interest" (in which event only 1 and 3 would yield ordinary income); expression of the consideration as a percentage (1 and 2); use of *either* the word "interest" or a percentage computation (1–3); or any form in which the consideration is separately stated (1–4). We note the ambiguity only because it demonstrates how tenuous the distinction is even as a matter of words. As a matter of substance, we need not dwell on the possible variants, for the short answer is that all the forms of expression mean exactly the same thing.

If the payment is made when due, it is self-evident that there is no difference between a note promising to pay "$100 plus 6% interest" a year hence and a note promising to pay "$106" on the same date. In neither case are periodic payments made and in both cases the identical amount is paid on the due date. Nor does the different form of expression in itself have any significance for other purposes, since pre-payment and default penalties typically are (and in any event may be) provided for entirely separately—often with rates of interest wholly different from that applicable to the prescribed payments. Thus the basic rate of interest stated in a note is nothing

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[8] *Fisher* v. *Commissioner*, 209 F. 2d 513 (C.A. 6), certiorari denied, 347 U.S. 1014; *First Kentucky Co.* v. *Gray*, 309 F. 2d 845 (C.A. 6).

more than an alternative way of expressing the amount to be paid on a particular date. If the note has no fixed due date, it is by far the most convenient form of expression, since the only alternative would be to include a schedule prescribing the exact amount to be paid on each date that the borrower might choose to pay the note. If, however, the note has a fixed due date, and if interest is not to be paid currently, there is little to choose between the two forms of expression: "$100 plus 6% interest" and "$106" mean exactly the same thing and, if anything, the latter has the virtue of greater simplicity. The only difference between the two forms of expression, in short, is that in one case the consideration to be paid for the use of the money is expressed as a formula ($100 times 6%), and in the other case the computation is made in advance and the consideration is expressed as an absolute amount ($6). The difference is that between the expressions "2 times 2" and "4."

Since notes cast in the two forms of expression are in truth identical things, it is perhaps unfortunate that different language has traditionally been used to describe them. A note promising to pay $100 plus 6% interest in one year has traditionally been called an "interest-bearing" note notwithstanding that the stated interest "rate" has no significance beyond prescribing a computation that might as well have been made at the outset. A note, also issued for $100, promising to pay $106 in one year, on the other hand, has traditionally been described as a "non-interest-bearing" note issued at a "discount." In truth, of

course, the note is equally "interest-bearing": the only difference is that the interest is not given a name and is in the form simply of the additional $6 the borrower promises to pay over the amount borrowed. And the statement that the note was issued at a $6 "discount" is but a converse form of the statement that the borrower promised to pay back $6 more than he borrowed. If "interest" by definition is an amount that a borrower agrees to pay a lender in exchange for the use of money—as it is—then "original-issue discount" is by definition interest. For the difference between the face amount of the note and what the lender pays to the borrower ("original-issue discount") is the same thing as the difference between what the borrower receives and what he agrees to repay ("interest").

There is, of course, at least a tangible (if insignificant) distinction between a note under which the interest is to be paid periodically and one under which it is to be paid only on maturity. But that is not the distinction drawn either by the court below or by respondent. Both acknowledge, as they must, that interest is no less interest because paid only on maturity. The distinction they draw is between a note providing for the payment, at maturity, of an amount specifically named "interest" and a note providing for the payment of the same amount at the same time without giving it a name. And between those two things, there is, we submit, no difference at all.

2. Interest is merely "compensation for the use or forebearance of money" (*Deputy* v. *DuPont*, 308 U.S. 488, 498). We do not understand respondent to sug-

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gest that a fixed amount, added to the loan, which the borrower promises to pay to the lender is any less compensation for the use of the money than is the same amount when expressed as a percentage. There being nothing in the definition or concept of interest that requires it to be expressed as a percentage, both forms of compensation are equally "interest" and must be taxed as such. If, as respondent concedes, the amount received on a sale of an accrued right to be paid a percentage amount of compensation for the use of money is taxable as ordinary income rather than as capital gain, by the same token the amount received on a sale of an accrued right to be paid a fixed amount of compensation for the use of money is taxable as ordinary income. The only discernible difference is that in one case the compensation is named "interest" by the parties and in the other case is given no name. In a rational tax system nothing can turn on the parties' choice of labels, and the cases of this Court rejecting such distinctions are legion.[7]

The identity of the two forms of compensation from the *borrower's* point of view has long been recognized by the decisions of this and other courts holding that, to the issuer, the inevitable "loss" on redemption of a bond issued at a discount is no less a cost of obtaining the use of money than is stated interest and, hence, that it may be amortized over the life of the loan and be deducted from ordinary in-

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[7] See, *e.g.*, *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Helvering* v. *F. & R. Lazarus & Co.*, 308 U.S. 252.

come. *Helvering* v. *Union Pacific Co.*, 293 U.S. 282; *Old Mission Co.* v. *Helvering*, 293 U.S. 289; *Great Western Power Co.* v. *Commissioner*, 297 U.S. 543; *Western Maryland Ry. Co.* v. *Commissioner*, 33 F. 2d 695 (C.A. 4); *American Smelting & Refining Co.* v. *United States*, 130 F. 2d 883, 885 (C.A. 3). As this Court said in the *Union Pacific* case, the discount at which bonds are issued is but a factor "in arriving at the actual amount of interest paid for the use of capital procured by a bond issue. The difference between the capital realized by the issue and par value, which is to be paid at maturity, must be added to the aggregate coupon payments in order to arrive at the total interest paid" (293 U.S. at 286). As early as 1929, Judge Parker, speaking for the Fourth Circuit, held that original-issue discount "is in reality additional interest payable upon the maturity of the bonds, and a proportionate part of it accrues each year and should be treated as interest paid or accrued on the bonds for that year." *Western Maryland Co.* v. *Commissioner*, *supra*, 33 F. 2d at 696. And if original-issue discount is to be treated, to the borrower, as a cost of obtaining the use of money, it must be treated, to the lender, as an amount earned by putting his money out to hire—to wit, ordinary income, whether called "interest" or given another name.

The identity of original-issue discount and stated interest from the *lender's* point of view—and the necessity of correlating the treatment of the borrower and the lender—has also been recognized by numerous recent decisions of the lower courts. With the

sole exception of the Sixth Circuit, the lower courts—the First, Second, Third, Fifth and Ninth Circuits, the Court of Claims, and the Tax Court—are uniform in holding that original-issue discount, whether recognized by accrual or realized by a sale or redemption, is taxable as ordinary income to the lender.[8]

Could any doubt remain about the matter, it is answered by the established doctrine that the capital-gains provisions are to be narrowly construed to confine the preferential treatment they afford to transactions plainly within their underlying purpose. *Corn Products Co.* v. *Commissioner,* 350 U.S. 46, 51–52; *Commissioner* v. *Gillette Motor Co.,* 364 U.S. 130; *Commissioner* v. *P. G. Lake, Inc.,* 356 U.S. 260; *Watson* v. *Commissioner,* 345 U.S. 544. A right to promised compensation in a fixed amount for the use of money is no more a "capital asset" than is the constitutional right to just compensation for the temporary use of property by the government (*Gillette*). If land is sold with an unharvested crop, the portion of the proceeds attributable to the unharvested crop is taxable as ordinary income notwithstanding that, as a matter of State law, the crop is deemed a part of the "real estate" until it is severed (*Watson*). If a growing crop of uncertain value is treated as an ordinary-income item, *a fortiori* an accruing right to be paid a fixed sum of money as compensation for the use of money is an ordinary-income item. Nor can the "bunching" rationale invoked by the district court (R. 28–29) justify its result, for there is no dif-

[8] See note 4, *supra*.

ference in that respect between original-issue discount and stated interest which is payable only on maturity, and it is conceded that the latter must be treated as ordinary income.

3. Since original-issue discount and stated interest payable at maturity are identical things, and since the proper treatment of the latter is conceded, it is perhaps unnecessary that we distinguish, from the transaction in this case, other kinds of transactions that involve an element of accretion which, although economically like interest in many respects, is not generally taxed as interest, at least under the existing decisions: whatever it is that distinguishes the accretion element in such cases from stated interest equally distinguishes it from the latter's twin, original-issue discount. In order to make clear the limited scope of the issue before the Court, however, it is appropriate that we note the unique characteristics which stated interest and original-issue discount have in common and which distinguish them both from somewhat similar elements involved in other transactions.

If *A* gives *B* \$100 in exchange for a note promising to pay, in one year, either "\$100 plus 6% interest" or "\$106", it is evident that the additional amount *A* is entitled to receive upon maturity is (1) a specific and readily identifiable amount of money (\$6); (2) an amount of money to be paid *by the borrower* to the lender; and (3) an amount that is agreed to paid solely as an inducement to the lender to give the borrower the use of money under terms admittedly giving rise to a bona fide "indebtedness." As we will

show, those characteristics sharply distinguish transactions involving stated interest or original-issue discount from (a) the purchase of bonds at a "market discount"; (b) the issuance of non-interest-bearing notes in exchange for property other than money; and (c) transactions in which the purported "interest" may represent something other than compensation for the use of money.

a. Market discount.—Assume that a $100, 30-year bond paying $4 interest annually is originally issued at par. Sixteen years later, at a time when, because of a rise in interest rates, comparable bonds are being issued at 5%, the original bondholder sells the bond on the market. Other things being equal, a purchaser would only pay about $90 for the bond, the price at which his receipts from the bond (the annual $4 interest payments plus the $10 "gain" on redemption in 14 years) would give him a 5% yield from his investment.[9] From the ***buyer's*** point of view, the transaction does not differ significantly from the purchase for $90 of a newly-issued 14-year bond in the face amount of $90 bearing 5% interest or—what amounts to the same thing—in the "face amount" of $100 paying 4% in stated interest and 1% in "original-issue discount" interest. Since the buyer's $10 "gain" on the redemption of the bond is a return from his investment automatically accruing over time, it is economically much like "interest" and perhaps

[9] The current $4 interest payments provide a 5% return on $80 of his investment and the $10 "gain" on redemption provides a 5% return (compounded for 14 years) on the remaining $10 of his investment.

ought to be taxed as such. From the issuing corporation's point of view, however, the transactions are very different, for the only "interest" it is *paying* is the 4% interest it originally contracted to pay when it issued the bond at par. The price at which the bond changes hands on the market in no way affects the issuer or the character, from its point of view, of the payments it has obliged itself to make. The courts, in turn, have traditionally looked only at the character of the payments made by the debtor, and have accordingly not treated "market discount" as giving rise to an "interest" accretion to the purchaser.[10]

Whether it is sound to make the tax treatment of the purchaser turn upon the intrinsic character of the payments made by the issuer—rather than upon the economic significance of the transaction to the particular purchaser—is not a question that need be considered here. The sharply distinguishing characteristic of original-issue discount is that it, like stated interest and unlike market discount, represents an amount paid *by the borrower* for the use of the money: it takes its character as "interest" from the original transaction between borrower and lender, not from some intervening sale of the obligation that arguably changes the character of the receipts in the hands of the particular holder. There is also, of course, a very important pragmatic difference that makes it far more crucial that stated interest and original-issue discount

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[10] See *Jaglom* v. *Commissioner*, 303 F. 2d 847, 850–851 (C.A. 2). But see Brandis, *Effect of Discount or Premium*, 19 No. Car. L. Rev. 1, 8–9, 16–17.

be treated as interest to the noteholder than it is that market discount be so treated—to wit, that the borrower is admittedly entitled to deduct stated interest or original-issue discount as a cost of obtaining the use of money, while no one is entitled to deduct the excess of the redemption proceeds over the market price at which a purchaser happens to buy a bond that was originally issued at par.

b. Notes given in exchange for property.—A seller of property will normally insist upon a larger payment for the property if the payment is to be deferred than he would if payment were to be made immediately, and the increase in the amount demanded and paid is in the nature of interest—*i.e.,* compensation for the deferral of payment. Yet if the interest element is not identified as such in the contract or notes, the courts have not generally treated any part of the deferred payments as interest, either for purposes of allowing the buyer an interest deduction or for purposes of taxing part of the payments as ordinary income to the seller.[11] The basic problem in such transactions is that, since the notes are given for property rather than for money, the extent to which the payments constitute interest, even in an economic sense, cannot readily be identified. Findings of the "fair market value" of the property are too uncertain to provide a satisfactory basis for dividing the payments, and the courts have been reluctant, without

[11] *Paine* v. *Commissioner*, 236 F. 2d 398 (C.A. 8); *MacDonald* v. *Commissioner*, 76 F. 2d 513 (C.A. 2); *Henrietta Mills, Inc.* v. *Commissioner*, 52 F. 2d 931 (C.A. 4); *Kingsford Co.* v. *Commissioner*, 41 T.C. 646.

explicit statutory authority (since supplied [12]), simply to impute a "reasonable" interest rate—*i.e.*, on the assumption that the parties increased the price for deferred payment by the amount of the interest that a reasonable man would have insisted upon as compensation for the deferral in like circumstances.

While the sufficiency of the reasons for not imputing interest in such transactions may be doubted, it is enough for present purposes to note that no such problem of measurement is presented when a note is given in exchange for *money*. In such transactions, whether they are cast in the form of original-issue discount or of stated interest, the additional amount that the borrower agrees to pay in exchange for the use of the money is readily identified as simply the excess of the amount of money the borrower is required to pay back over the amount of money furnished by the lender. The sharp distinction drawn between non-interest-bearing notes issued for money and those issued for property is also established by the fact that the borrower of *money* is allowed a deduction for the "discount" while the buyer of *property* is not.

c. Mislabeled transactions.—It is true, of course, that the form of a promise to pay money does not necessarily determine its economic character or its proper tax treatment. If, for example, *A* agreed to pay *B* 20% "interest" on a loan only because *B* was his son, some part of the payments ought obviously to be

[12] Internal Revenue Code of 1954, § 483, as added by Revenue Act of 1964, § 224, 78 Stat. 19.

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treated as a gift notwithstanding the "interest" label. Similarly, under "thin capitalization" principles, instruments in the form of "notes" with stated interest are often treated for tax purposes as actually representing an "equity" rather than a "debt" interest, with the consequence that the purported "interest" payments are treated as non-deductible "dividends."[13] And what is true of notes with stated interest may equally be true of notes issued at a discount. Thus "original-issue discount" does not *necessarily* represent interest on indebtedness any more than stated "interest" does. In either case, an economic analysis of the particular transaction might lead to the conclusion that the promised payment should be characterized as something entirely different from "interest"—*e.g.*, as a gift, as a dividend, as compensation for services, as payment for a capital asset, or as any other kind of payment which taxpayers might choose to cast in the form of "interest" or of "original-issue discount."[14]

Obviously, no such question is presented by this case. The parties dealt at arm's-length, the notes un-

[13] See Surrey & Warren, *Federal Income Taxation*, pp. 1187–1204 (1960).

[14] It was a question of that sort that was involved in *Lubin* v. *Commissioner*, 335 F. 2d 209 (C.A. 2). The court, although reaffirming its view announced in *Dixon* that original-issue discount must normally be accounted for as interest, held that on the unique facts of that case the excess amount to be paid under the "note" over the sum advanced did not represent interest for the use of the taxpayer's money but rather a participating share in the profits from a joint venture for the purchase of some stock which was believed to have been undervalued by the seller.

questionably represented true indebtedness rather than an equity interest, and the amount agreed to be paid in excess of the amount advanced was admittedly but compensation for the use of the money. Any such question, moreover, would have as much bearing on the treatment of interest labeled as such as it would on the treatment of a payment labeled as "original issue discount," and respondent concedes that the amounts at issue would properly be taxable as ordinary income had they been labeled as "interest" in the notes.

In short, what this case involves, and all it involves, is the treatment of (1) a specific, identifiable, amount of money (2) agreed to be paid by a borrower to a lender (3) as bargained-for consideration for the use of money. The proper treatment of transactions in which one or more of those elements is lacking is not our present concern and need not be considered by the Court.

II

THE AMOUNT PROMISED TO BE PAID ON A NOTE IN EXCESS OF THE AMOUNT FOR WHICH IT WAS ISSUED HAS HISTORICALLY BEEN TREATED AS INTEREST

The courts below do not suggest that a promise to pay a fixed amount, in addition to the amount borrowed, as compensation for the use of the borrowed money (*i.e.*, original-issue discount) can logically be distinguished from a promise to pay the same amount expressed as a percentage of the amount borrowed (stated interest). The ground for the decision below—at least that given by the district court—was rather that the distinction, however illogical, was

firmly settled in the law prior to the 1954 Code and that it would be a "change" in the law for the courts now to reject it. To justify perpetuating an admittedly illogical distinction solely on the grounds of its antiquity would require, at the very least, a far more conclusive showing of a long-continued acceptance of the rule than that made by the district court, even accepting at face value its interpretation of the materials it cites. In fact, however, the history establishes just the opposite. There are, to be sure, the usual number of instances of inconsistency and backtracking to be found in the formative development of a body of law as intricate as the tax system. But the basic character of original-issue discount as interest in another form was recognized at an early date and whatever inconsistencies there may have been in its treatment were resolved long prior to the 1954 Code. The recent decisions of the other courts treating the proceeds of a sale of a note attributable to original-issue discount as ordinary income were thus evolutionary rather than revolutionary; they merely recognized the unavoidable implications, in the sale context, of the long-recognized identity of "original-issue discount" and "interest."

The decision below was based largely on an earlier decision of the same court. As our discussion of that case will show, it was not until after 1953 that it was first squarely held that the proceeds of a sale of a bond *with stated interest* could be allocated in part to the interest earned up to date of sale and the part so allocated be taxed as ordinary income. Since there were

no pre-1954 cases so holding as to stated interest, it is not surprising that there were none so holding as to original-issue discount. To determine whether there was an established *distinction* between the two forms of interest, therefore, it is necessary to examine other contexts in which the distinction might have been important; deductibility of the payments by the borrower; application of the tax exemption accorded to "interest" on tax-exempt bonds; and accruability of income by accrual-basis taxpayers. In none of those contexts, we will show, did such a distinction ever become established. Since stated interest and original-issue discount were treated alike in every other context, it was inevitable that, once it was recognized that a bond with accrued interest was not a unitary "capital asset" and that the portion of the proceeds of its sale attributable to the accrued interest might be taxed differently from the portion attributable to the underlying asset, the rule would be, as it has been, applied equally to both forms of interest.

1. The courts below relied primarily on the Sixth Circuit's own prior decision, in 1944, in *Commissioner* v. *Caulkins,* 144 F. 2d 482. Since the Commissioner originally acquiesced in that decision [15] and did not announce his change of position until 1953,[16] it is

[15] 1944 Cum. Bull. 5.

[16] Rev. Rul. 119, 1953-2 Cum. Bul. 95, limited the acquiescence in *Caulkins* "precisely to what was there decided under the particular facts of that case." In 1955, the acquiescence was withdrawn in its entirety, except as to taxpayers who had purchased the particular Accumulative Investment Certificates involved in *Caulkins* prior to withdrawal of the acquiescence. Rev. Rul. 55-136, 1955-1 Cum. Bull. 7, 213, republished as Rev. Rul. 56-299, 1956-1 Cum. Bull. 603.

important to note precisely what that case held and what its true status is today. We will show that the decision made no distinction between original-issue discount and stated interest but was rather based on a ground that has since been repudiated even by the Sixth Circuit itself and which even respondent acknowledges can no longer be maintained.

The taxpayer in *Caulkins* purchased from a corporation an "Accumulative Installment Certificate" under which he made ten annual payments totaling approximately $15,000 and then surrendered the certificate for a payment of $20,000, an amount representing a cumulative return on his investment of 5½%, which figure was in turn printed on the face of the certificate.[17] The court held that the $5,000 gain was taxable as capital gain under § 117(f) of the 1939 Code, which provided that:

> * * * amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidence of indebtedness issued by any corporation * * *, with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

The court based its decision, not upon a distinction between original-issue discount and stated interest, but solely upon its reading of § 117(f) as specifically directing that *all* amounts received upon the retirement of such a certificate, whether representing interest or not, be accounted for as the proceeds of a sale or exchange of a capital asset—*i.e.*, as capital

[17] Query: Was that "stated interest" or "original-issue discount"?

gain or loss. The court expressly agreed that the \$5,000 increment, identical to interest compounded at 5½% for the period, was "consideration paid for the use of the amounts paid in" and thus "interest" as defined by this Court in *Deputy* v. *Dupont, supra,* and acknowledged that it was "difficult to perceive any practical reason for taxing increment of the type involved here differently from ordinary income" (p. 484). Yet the \$20,000 was plainly an "amount received on retirement of the certificate" and, since the court read § 117(f) as specifically providing that "amounts received on retirement of the securities listed should be calculated as capital gain or capital loss" (ibid.), it concluded that it made no difference that a part of proceeds represented interest. What the court held, in short, was not that original-issue discount was different from stated interest, but that § 117(f) did not permit of any apportionment of the "amounts received * * * upon the retirement" of certificates of indebtedness and required that the proceeds be treated as a unitary amount received in exchange for a capital asset.

To the extent that the decision treated § 117(f) as itself authorizing capital gains treatment—which, on its face, is what the decision did—it was plainly mistaken. The basic definition of capital gains, not cited by the court, was § 117(a)(4), which defined capital gain as "gain from the sale or exchange of a capital asset." All that § 117(f) did was to satisfy the "sale or exchange" requirement, thereby overcoming the prior rulings that a retirement or redemp-

tion of a security was not a sale or exchange.[18] Whether the thing in "exchange" for which the proceeds were received was a "capital asset"—in whole or only in part—was a quite separate question, and it seems plain that that question was not meant to be answered differently in the case of a retirement than in the case of an actual "sale or exchange."

It is perhaps possible, although the opinion in no way suggests it, that the court assumed that a debt obligation with accrued interest would, on a *sale*, be treated as a single indivisible "capital asset." If that were so, instead of making the obvious error of reading § 117(f) as intended to accord preferential treatment to retirements rather than merely put them on a par with sales and exchanges, the court would have made a somewhat more subtle but even more fundamental error. A "capital asset" is defined in § 117(a)(1) simply as "property", and in property-law terms a right to receive the interest earned on a debt obligation may well be regarded, not as an independent property right separate from the obligation itself (at least until it is severed), but simply as one of the incidents of ownership of the underlying obligation. It would therefore have required no more than the common but fundamental error of assuming that property-law concepts are controlling for capital-gains purposes[19] for the court to have made the mistake of assuming that a debt obligation with accrued interest was one indivisible thing the whole of which must be treated as a "capital asset."

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[18] See *Fairbanks* v. *United States*, 306 U.S. 436.

[19] An error which this Court has many times been required to point out. *E.g.*, *Commissioner* v. *Gillette Motor Co.*, 364 U.S. 130; *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Palmer* v. *Bender*, 287 U.S. 551.

But whether based on an attribution to § 117(f) of a specific purpose to give capital-gain treatment to all retirement proceeds regardless of the treatment of sales (the apparent holding) or on an unstated assumption that a debt obligation is a single indivisible "capital asset" for all purposes, *Caulkins* has been wholly repudiated by later cases the soundness of which is not challenged even by respondent. In 1953, this Court held that, notwithstanding that for property-law purposes an unharvested crop is treated as a part of the "real estate" until it is severed, land with a growing crop is not for tax purposes a unitary "capital asset" and that the portion of the proceeds of its sale allocable to the unharvested crop (in proportion to its value) must be separately accounted for as ordinary income. *Watson* v. *Commissioner,* 345 U.S. 544. And in 1954, the Sixth Circuit itself held that, on the sale of a bond with accrued interest, the portion of the proceeds attributable to the interest earned up to the date of the sale must be separately accounted for and taxed as ordinary income, thus becoming the first court of appeals squarely to so hold. *Fisher* v. *Commissioner,* 209 F. 2d 513. Other courts have uniformly agreed,[20] also recognizing, after some hesitation, that whatever is true of sales must also be true of retirements inasmuch as the only purpose of § 117(f) was to equate retirements with sales.[21] Because of those decisions—and the compelling anal-

[20] See note 2, *supra.*

[21] The cases involving stated interest (note 2, supra) were all cases of sales rather than retirements, but the cases involving original-issue discount involved both sales and retirements

ogy of this Court's decision in *Watson* v. *Commissioner*—it is now universally regarded as settled, if there were ever room for doubt, that on either the sale or redemption of a debt obligation the portion of the proceeds attributable to the interest earned to the date of the sale is taxable as ordinary income.

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and ultimately rejected any distinction between the two forms of disposition.

The Tax Court initially adhered to the distinction between sales and redemptions suggested by the *Caulkins* case, holding that the interest element was separately taxable in the case of a sale (*Paine* v. *Commissioner*, 23 T.C. 391, 401, reversed on other grounds, 236 F. 2d 398 (C.A. 8); *Shattuck* v. *Commissioner*, 25 T.C. 416, 423; *Stanton* v. *Commissioner*, 34 T.C. 1, 6) but that in the case of a *redemption* § 117(f) required all the proceeds, without allocation, to be accounted for only as capital gain or loss (*Goodstein* v. *Commissioner*, 30 T.C. 1178, 1193, affirmed on other issues, 267 F. 2d 127 (C.A. 1); *Morgan* v. *Commissioner*, 30 T.C. 881, reversed, 272 F. 2d 936 (C.A. 9); *Kormendy* v. *Commissioner*, decided April 15, 1959 (P-H Tax Ct. Mem. Dec. ¶ 59,072); see also *Rosen* v. *United States*, 185 F. Supp. 805 (W.D. Pa.), reversed, 288 F. 2d 658 (C.A. 3); *Wood* v. *United States*, decided November 15, 1960 (6 A.F.T.R. 2d 5991), reversed *sub nom. United States* v. *Harrison*, 304 F. 2d 835 (C.A. 5), certiorari denied, 372 U.S. 934). Later, however, the Tax Court expressly rejected the distinction and thereafter held the interest element to be separately taxable on either a sale or a redemption. *Gibbons* v. *Commissioner*, 37 T.C. 569 (redemption); *Schwartz* v. *Commissioner*, 40 T.C. 191 (redemption); *Lubin* v. *Commissioner*, decided October 24, 1963 (P-H Tax Ct. Mem. Dec. ¶ 63,292), reversed on other grounds, 335 F. 2d 209 (C.A. 2) (redemption); *Oglansky* v. *Commissioner*, decided January 23, 1963 (P-H Tax Ct. Mem. Dec. ¶ 63,018) (sale).

The courts of appeals from the outset rejected the *Caulkins* distinction between sales and redemptions and uniformly held the interest element separately taxable in either case. Redemptions: *Commissioner* v. *Morgan*, 272 F. 2d 936 (C.A. 9); *Rosen* v. *United States*, 288 F. 2d 658 (C.A. 3); *United States* v. *Harrison*,

Those later cases, it may be seen, fully exposed the basic error of the decision in *Caulkins*. And once it was acknowledged that proceeds of sale attributable to accrued stated interest were taxable as ordinary income, it followed automatically—as all the courts, with the sole exception of the Sixth Circuit, have held—that the same rule applied to interest in the form of a promise to pay a fixed, rather than a percentage, amount (*i.e.*, "original-issue discount"). *Caulkins* itself had drawn no distinction between the two forms of interest and, since no rational distinction can be drawn, the repudiation of the premise of *Caulkins* had precisely the same implication for both forms of interest. In short, neither *Caulkins* nor the Commissioner's subsequently withdrawn acquiescence were concerned with a distinction between stated interest and original-issue discount, and the reliance of the courts below on the decision and acquiescence to establish such a distinction was wholly misplaced.

2. Since it was not until after 1953 that the divisibility of the proceeds of a sale of debt obligation between principal and interest was put beyond doubt, the inquiry whether, before that time, interest in the form of original-issue discount was treated differently from stated interest must, as we have noted, look to

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304 F. 2d 835 (C.A. 5), certiorari denied, 372 U.S. 934; see also *Lubin* v. *Commissioner*, 335 F. 2d 209 (C.A. 2). Sales (in addition to those cited in note 2, *supra*): *Pattiz* v. *United States*, 311 F. 2d 947 (Ct. Cls.); *Real Estate Investment Trust of America* v. *Commissioner*, 334 F. 2d 986 (C.A. 1), pending on petition for certiorari, No. 620; *Dixon* v. *United States*, 333 F. 2d 1016, pending on certiorari, No. 486.

other contexts in which the nature of an item as "interest" is relevant. One such context is the treatment of the *borrower* and his right to deduct amounts he is required to pay in exchange for the use of borrowed money. If the interest is payable currently, there is no question of its deductibility either by an accrual-basis or a cash-basis taxpayer. If the interest is labeled as such but is payable only on maturity, there is likewise no question of the right of an accrual-basis taxpayer to accrue and deduct each year the portion of the interest allocable to that period of time. The question, then, is whether original-issue discount was treated any differently, and the answer is that it was not.

The regulations under the 1939 Code, in a provision dating back to 1918,[22] expressly provided that "If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds." Regs. 118, § 39.22(a)–17(c). As early as 1929, the Fourth Circuit sustained that treatment on the specific ground that original-issue discount "is in reality additional interest payable upon the maturity of the bonds, and a proportionate part of it accrues each year and should be treated as interest paid or accrued on the bonds for that year." *Western Maryland Ry. Co. v. Commissioner,* 33 F. 2d 695, 696. That view, as we have pointed out above (pp. 14–15, *supra*), was

[22] Treas. Regs. 33, Art. 150 (1918 ed.). The exact language quoted in the text was first adopted in Treas. Regs. 45, Art. 544(3)(a) (1920 ed.).

later endorsed by this Court, and since then there has been no doubt about the matter.

3. Another area in which the character of an item as interest is important is in the application of the exemption from the income tax accorded to "interest" from State and municipal bonds (§ 22(b)(4) of the 1939 Code; § 103 of the 1954 Code). By 1920, it was established that, if the original holder of a State bond held it to maturity and was then paid by the State an amount in excess of the price at which the bond was issued, the excess represented interest paid by the State and was therefore exempt from any tax.[23] At the same time, however, the Bureau ruled that on *sales* of exempt bonds no part of the gain—whether attributable to stated interest *or* to original-issue discount—was exempt from tax, giving as its reason that "no person other than the municipality can pay the interest borne by the obligations of the municipality (whether such interest is paid at a specified rate or in the form of realized discount)."[24] That ruling again treated "rate" interest and "discount" interest as the same, ruling only that the exemption of the interest when paid did not extend to the proceeds of a sale of the *right* to the interest. Up to that point the rulings followed an understandable, if perhaps formalistic, pattern. More obscure are the reasons for a ruling issued in 1927 holding that the interest element of the

[23] O.D. 647, 3 Cum. Bull. 123 (1920); O.D. 737, 3 Cum. Bull. 49 (1920). A contrary ruling issued in 1919 (O.D. 238, 1 Cum. Bull. 68) was revoked.

[24] O.D. 737, 3 Cum. Bull. 49 (1920); see also O.D. 762, 4 Cum. Bull. 31 (1921).

amount paid by a State in redemption of a bond issued at a discount was exempt only if paid to the original purchaser of the bond, and was not exempt if paid to a subsequent holder.[25] It is unnecessary to speculate about the rationale of that distinction,[26] for it was in any event short-lived.

In 1929, Congress by statute exempted the "interest" on Treasury bills from taxation and provided that "the amount of discount at which Treasury bills are originally sold by the United States shall be considered to be interest within the meaning of this subdivision." Act of June 17, 1929, 46 Stat. 19, 20. In their report on the bill, the House managers made plain that it was intended not only to exempt the increment realized by the original purchaser on redemption (the Bureau's position on State bonds) but also to exempt the portion of the proceeds realized by each successive holder attributable to the "interest" earned during his period of holding.[27] Thus Congress not only

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[25] G.C.M. 1455, VI-1 Cum. Bull. 87 (1927).

[26] Since the ruling reaffirmed the exemption of the increment when paid to the original holder, it in no way impaired the basic principle that original-issue discount was in its nature "interest." Indeed, there is nothing to indicate that the ruling would not have been applied equally to stated interest payable only at maturity.

[27] The report stated (H. Conf. Rep. No. 17, 71st Cong., 1st Sess., p. 2):

> Under the present law, when tax-exempt securities are sold at a discount in lieu of interest, any increase in value realized by the original purchaser is tax exempt; but no exemption is granted a subsequent holder. In order to prevent the application of this rule, the Senate amendment provides for the computation of interest at the original discount rate for the period during which the security is

agreed with the Bureau that original-issue discount was a form of interest but carried that principle to what seemed to it the logical conclusion—a proration of the exemption among all the successive holders.[28]

Although the 1929 Act applied only to Treasury bills, and not to State bonds, the Bureau accepted generally the underlying principle of the Act that, if the interest itself is exempt, so too should be the proceeds of a sale of the right to the interest earned

held, whether by the original purchaser or any subsequent holder. In other words, the original discount rate at which the security is sold is substituted for the interest rate fixed by the security itself in the case of an interest-bearing obligation. The amount of tax-exempt interest is apportioned among the holders according to the period of their holdings. Any gain in excess of this amount is taxable and any loss resulting from a sale or other disposition is allowed as a deduction.

The Treasury Decision implementing the Act adopted the treatment indicated by the report. T.D. 4276, VIII-2 Cum. Bull. 83 (1929).

[28] In the debates on the bill there was basic agreement by everyone that original-issue discount was in its nature interest and that any realized accretions in value attributable to the discount should therefore be wholly exempt from tax; the only dispute was over the need for a special provision and over the language that would best accomplish that result without also exempting gains attributable instead to fluctuations in the market value of the security. See 71 Cong. Rec. 2328–2333. How the gains would be taxed to the extent they were not exempt (*i.e.*, as ordinary income or as capital gain) was not as such the subject matter of the discussion. In any event, it is entirely possible that at that early date it was assumed that *any* gain on a sale of a bond would be taxable as capital gain, whether attributable to stated interest *or* to discount. There were many concepts of the tax law that were not developed by 1929, and it would be no surprise if the severability of an accrued income item from the underlying asset were one of them.

up to the date of the sale. Accordingly, in 1932 the Bureau revised its rulings on *State and municipal* bonds to afford the same treatment to original-issue discount on such bonds that Congress had prescribed for Treasury bills—*i.e.,* exempting from tax any amounts received by any holder that were attributable to the original-issue discount prorated over his period of holding.[29] The ruling was reaffirmed in 1940[30] and there the matter has since stood. In short, but for some uncertainties during the 1920's as to the proper application of the principle, which in turn were resolved at least by 1932, original-issue discount on State and municipal bonds has consistently been treated as interest for purposes of the statutory exclusion of "interest" from such bonds.

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[29] G.C.M. 10452, XI-1 Cum. Bull. 18 (1932); see also G.C.M. 13320, XIII-2 Cum. Bull. 138 (1934).

[30] G.C.M. 21890, 1940-1 Cum. Bull. 85, summarized the ruling position as follows:

> The amount of discount received at maturity on Treasury bills (T.D. 4276, C.B. VIII-2, 83 (1929)), on noninterest-bearing State bonds (G.C.M. 10452, C.B. XI-1, 18 (1932)), and on interest-bearing municipal obligations (I.T. 2629, C.B. XI-1, 20 (1932)) is held to be nontaxable income, and each purchaser of the bond before maturity is entitled to apportion the amount of discount at which the obligation was issued according to the period of his holding. The earned discount in the present case is, therefore, nontaxable income to the taxpayer.
>
> The courts have considered the nature of discount in cases involving private corporations and have held it to be in the "nature of deferred interest" which may be amortized, for income tax purposes, over the life of the bonds by deducting the annual proportion thereof from the issuing corporation's gross income each year as "accrued interest."

See also I.T. 3486, 1941-2 Cum. Bull. 76.

4. A final question to which the character of an item as "interest" is important is whether a lender who reports on the accrual basis must accrue the item as income as it is earned or may defer accounting until it is realized. In 1920, the Bureau ruled that original-issue discount on corporate bonds was not accruable as income by the holder notwithstanding that it was accruable as a deduction by the issuer.[31] The reason, though unclear, may have been simply the pragmatic one that, with the bonds frequently changing hands, it would impose an undue burden to require each holder to ascertain the original discount and account for it, a problem not encountered

[31] O.D. 475, 2 Cum. Bull. 211 (1920). O. 1024, 2 Cum. Bull. 189 (1920), also issued in the same year and the only ruling cited by the district court (R. 23–24), does not seem to us in point. The statute involved taxed nonresident foreign corporations only on "interest, rents, salaries * * * or other fixed or determinable, annual or periodic * * * income" from sources within the United States. The ruling held that income from buying and selling bank acceptances issued at a discount was not taxable under that provision. Although acknowledging that discount "is compensation for the use of money and as such resembles interest", it made the distinction that interest, unlike discount, "is payable annually or at shorter periods before maturity of the obligation." In view of the limitation of the statute to "annual or periodic" types of income, the distinction made seems to us a permissible one for purposes of that statute. But cf. I.T. 3889, 1941-1 Cum. Bull. 79. In any event, the distinction made by the courts below and by respondent is not that between currently payable interest and interest payable only on maturity but rather one between amounts payable at maturity which are called interest and those which are given no name.

by the issuer.[32] In 1922 and 1923, however, it was ruled that the annual increase in the redemption price of redeemable certificates, although not taxable to a cash-basis taxpayer until actual redemption, had to be accrued as "interest" by an accrual-basis taxpayer.[33] More significant was the ruling in 1925 requiring a bank lending money on discounted notes (*e.g.,* making a loan of $100 in exchange for the borrower's note for $106 payable in a year) to accrue the income earned each year, explaining that: "Bank discount is the compensation charged by the bank for the use of its money, and hence is earned in the same way as interest—by lapse of time. It follows that under the accrual system such discount is income to the bank as it is earned."[34] The ruling also expressly distinguished market discount (*i.e.,* the difference between the price at which the bank purchased interest-bearing notes on the market and their face amount, see pp. 18–20, *supra*) which it held need not be accrued.

In the same year that the ruling last cited was issued, the Board of Tax Appeals likewise held that a bank must accrue its income from discounted notes. *Chatham S. Phenix National Bank* v. *Commissioner,* 1 B.T.A. 460. Two years later, the Board held that a bank could not amortize the difference between the face amount of bonds and securities held in its port-

[32] That may also have been the explanation for the distinction once drawn between the original purchaser and subsequent holders of State bonds. See pp. 33–34, *supra.*

[33] T.D. 3301, I–1 Cum. Bull. 100 (1922) (United States savings certificates); I.T. 1684, II–1 Cum. Bull. 60 (1923) (similar instruments issued by a bank).

[34] S.M. 3820, IV–2 Cum. Bull. 32 (1925).

folio of investments and the price it had paid for them. *Corn Exchange Bank* v. *Commissioner,* 6 B.T.A. 158. Whether any of the securities had been originally issued at a discount is not indicated in the opinion and, whatever the fact may have been, the failure of the Board to focus on the distinction between market discount and original-issue discount makes the decision little authority on the treatment of the latter. In any event, in later years the Board has repeatedly reaffirmed its holding in the *Phenix National Bank* case that a bank must accrue income from discounted notes,[35] thus consistently recognizing that original-issue discount is but another form of interest.

In 1935, the Bureau again affirmed its view of original issue discount as a form of interest, ruling that accrual-basis taxpayers must accrue the annual increment in value attributable to the discount at which United States savings bonds were issued.[36] While the statute authorizing the bonds specifically provided that the discount "shall be considered as interest," the ruling relied, not on that provision, but on the 1925 ruling requiring banks to accrue discounts on loans (S.M. 3820, note 34, *supra*), noting that the "situation is analogous to that where a noninterest-bearing loan is made at a discount which is included in the face amount of the note."

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[35] *Chicago Acceptance Co.* v. *Commissioner*, 12 B.T.A. 150, 152 (1928); *Vancoh Realty Co.* v. *Commissioner*, 33 B.T.A. 918 (1936); *Motors Securities Co., Inc.* v. *Commissioner*, decided October 30, 1952 (P-H Tax Ct. Mem. Dec., ¶ 52,316).

[36] G.C.M. 15875, XIV-2 Cum. Bull. 100 (1935).

By 1941,[37] Congress regarded it as settled not only that original-issue discount must be accrued by an accrual-basis taxpayer but, indeed, that the proceeds of a sale attributable to the discount were taxable as ordinary income rather than capital gain. By the Public Debt Act of February 19, 1941, 55 Stat. 7, 9, Congress had repealed the exemption of Treasury bills from taxation, providing that the interest on such obligations "shall not have any exemption, as such, and loss from the sale or other disposition of such obligations shall not have any special treatment, as such, under Federal tax Acts now or hereafter enacted."[38] Later that year, in considering the bill that became the Revenue Act of 1941, the Finance Committee took note of the consequence of the repeal of the exemption and the resulting applicability to Treasury bills of the normal rules of accounting (S. Rep. No. 673, Part 1, 77th Cong., 1st Sess., pp. 30–31):

> The requirements of existing law with respect to Treasury bills issued on or after March 1, 1941 [the effective date of the Public Debt Act], impose on taxpayers the duty of making burdensome computations. The portion of the gain attributable to the original discount on such bills is considered as interest and the remainder is treated as a capital gain. Thus, where such a bill is sold by the original holder for an amount in excess of the purchase price

[37] For a contemporaneous analysis demonstrating the treatment of original-issue discount as interest for purposes both of accural accounting and tax exemption, see Brandis, *Effect of Bond Discount or Premium*, 19 No. Car. L. Rev. 1 (1940).

[38] Despite that express language, a ruling issued on the treatment of Treasury bills shortly after the withdrawal of the

plus the issuing discount accrued to the date of sale, allocation to interest and capital gain is required. In the case of a loss resulting from the sale of such a Treasury bill, the loss is treated as a capital loss and must be segregated as such. Being a short-term capital loss, it is allowable only to the extent of short-term capital gains. Moreover, the existing rule that the original discount on Treasury bills accrues ratably over the entire life of the bills requires each successive taxpayer holding a particular bill to ascertain the amount of such discount

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exemption relied on the fact that the 1929 exemption statute (quoted at p. 34, *supra*) had expressly provided that the discount at which Treasury bills were issued "shall be considered to be interest." I.T. 3486, 1941–2 Cum. Bull. 76. But the 1929 Act had provided only that the discount should be considered as interest "within the meaning of this subdivision"—*i.e.*, for purposes of the exemption—and that provision could thus not of its own force control the treatment of Treasury bills after Congress not only withdrew the exemption but denied to such bills any "special treatment" at all. The significance of the 1929 provision, that is, derived not from its force as a statutory command (no longer operative) but from its recognition of the underlying *principle* that discount is in fact but another form of interest, a principle that the Bureau in 1941 quite properly carried forward to the treatment of Treasury bills after the exemption was repealed just as it had in 1932 carried it over to the treatment of State bonds (see pp. 35–36, *supra*). Moreover, the committee report quoted in the text, while expressing the same view as to the proper treatment of Treasury bills under existing law, in no way implied that the treatment was the product of some specific statutory command rather than of the application of general principles—indeed, the provision being reported was not limited to Treasury bills but applied also to State bonds to which the 1929 provision had never applied. Finally, as noted below (note 40), the Senate committee report on the 1954 Code relied on I.T. 3486 as evidence of the general principles being applied, not as a ruling peculiar to Treasury bills.

which is treated as accruing during the period for which he held the bill.

In the case of short-term obligations—where gains or losses not attributable to the discount were unlikely to be significant and the time of accounting made little difference—it was obvious that such precise accounting did not make enough difference to warrant the burden of making it. The Committee accordingly recommended, and Congress enacted, two new provisions of the 1939 Code dealing expressly with all governmental obligations (State as well as federal) issued at a discount with a term not exceeding one year: § 117(a)(1)(D), excluding such obligations from the definition of a "capital asset"; and § 42(c), providing that "the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold or otherwise disposed of." Revenue Act of 1941, § 115, 55 Stat. 687, 698. The result was to defer all accounting until final disposition of the obligation and to require that the entire gain then be treated as ordinary income. As to all private obligations and all long-term government obligations, however, Congress obviously intended the "existing law"—requiring, in its view, that the proceeds attributable to the discount and those attributable to market fluctuations be separately accounted for, the former as ordinary income and the latter as capital gain or loss—should continue to apply.[39]

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[39] Examples of the application of §§ 42(c) and 117(a)(1)(D), in contrast with the rules otherwise applicable, are given in Regs. 118, § 39.117(a)-1(d), *infra*, p. ~~48~~. 51.

In the same Act, Congress also added § 42(b) to the 1939 Code (*infra*, p. 47), applicable to any "noninterest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals," including private as well as governmental obligations. If "the increase in the redemption price of such obligation occurring in the taxable year does not (under the method of accounting used in computing his income) constitute income to [the taxpayer] in such year," the statute allows the taxpayer to elect to include it in income. The committee reports explained that under existing law an accrual-basis taxpayer was required to accrue the annual increase but a cash-basis taxpayer had to report the entire increase in value all in the year of redemption; the purpose was to give cash-basis taxpayers an option to report the increases annually. H. Rep. No. 1040, 77th Cong., 1st Sess., pp. 40–41; S. Rep. No. 673, Part 1, 77th Cong., 1st Sess., p. 29. In that provision also, therefore, Congress acted on the premise that, under existing law, accrual-basis taxpayers were required to accrue original-issue discount.[40]

In sum, not only is original-issue discount logically indistinguishable from stated interest (as shown in

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[40] Unfortunately, what Congress regarded as settled in 1941 became unsettled by the Sixth Circuit's decision in *Caulkins* in 1944 (*supra*, pp. 25–31). To overcome that decision, Congress adopted a new provision in the 1954 Code (§ 1232) expressly making any gain on sale or redemption of an obligation taxable as ordinary income to the extent of any original issue discount. Although reaffirming once again the long-standing view of Congress that original-issue discount "is a form of interest income" and noting the settled law that discount "is deductible as an interest

Point I), but it has from an early date been treated as interest for purposes of deductibility by the borrower, application of the exemption of "interest" on State bonds, and accrual accounting. In the Revenue Act of 1941, moreover, Congress not only recognized that it was treated as interest under existing law but, acting on that assumption, expressly excepted short-term governmental obligations from the rules otherwise applicable to obligations issued at a discount. Far from requiring that an admittedly illogical distinction be perpetuated (as the district court thought),

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payment" by the issuer, the reports reflected the confusion created by *Caulkins* as to the treatment of the gain to the holder. H. Rep. No. 1337, 83d Cong., 2d Sess., p. 83; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 112. The House committee report was undiscriminating, stating that under "existing law" any gain from either a retirement or a ~~redemption~~ sale of a bond was treated as a capital gain even though in fact a part of it represented original-issue discount, "a form of interest income." Since *Caulkins* had been based specifically on the redemption provision (§ 117(f)), and no case had so held as to sales, the committee's comments on the existing law (hardly approving in any event) were at the very least overbroad. The Senate committee was more precise, noting that under "section 117(f) of present law" there is "some uncertainty" as to the treatment of the proceeds of *retirement* of a bond issued at a discount, citing I.T. 3486, 1941-2 Cum. Bull. 76 (see note 38, *supra*) "as compared with" *Caulkins*. The main significance of the 1954 reports, we submit, is that both committees recognized that original-issue discount in fact is "a form of interest income," that it has always been deductible as "interest" by the issuer, and that it plainly ought to be taxed as ordinary income to the holder. The committees disagreed about what the existing "law" or "uncertainty" was—with the Senate committee correctly noting that the uncertainty created by *Caulkins* went only to the treatment of retirements under § 117(f)—but they both agreed that the result reached by *Caulkins* was wrong in principle and that the proper treatment should be made clear for the future.

the history of the treatment of original-issue discount confirms what is obvious: that bargained-for compensation for the use of borrowed money is interest, and must be taxed as such, by whatever name the parties choose to call it.

CONCLUSION

For the reasons stated, the judgment below should be reversed.

Respectfully submitted.

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February 1965.

APPENDIX

A. Internal Revenue Code of 1939 and Regulations 118.

Internal Revenue Code of 1939 (26 U.S.C., 1952 ed.):

Sec. 22. Gross Income.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived * * * from interest, * * * or gains or profits and income derived from any source whatever. * * *

* * * * *

Sec. 41. General Rule.

The net income shall be computed upon the basis of the taxpayer's annual accounting period * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayers; * * *.

Sec. 42. Period in Which Items of Gross Income Included.

(a) *General Rule.*—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

(b) *Noninterest-bearing Obligations Issued at Discount.*—If, in the case of a taxpayer owning any noninterest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals or owning an obligation described in paragraph (2) of subsection (d), the increase in the redemption price

of such obligation occurring in the taxable year does not (under the method of accounting used in computing his net income) constitute income to him in such year, such taxpayer may, at his election made in his return for any taxable year beginning after December 31, 1940, treat such increase as income received in such taxable year. * * *

(c) *Short-term Obligations Issued on Discount Basis.*—In the case of any obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of.

(d) *Matured United States Savings Bonds.*—In the case of a taxpayer who—

(1) holds a series E United States savings bond at the date of maturity, and

(2) pursuant to regulations prescribed under the Second Liberty Bond Act retains his investment in the maturity value of such series E bond in an obligation, other than a current income obligation, which matures not more than ten years from the date of maturity of such series E bond,

the increase in redemption value (to the extent not previously includible in gross income) in excess of the amount paid for such series E bond shall be includible in gross income in the taxable year in which the obligation is finally redeemed or in the taxable year of final maturity, whichever is earlier. The provisions of this subsection shall not ap-

ply to a corporation, and shall not apply in the case of any taxable year for which the taxpayer's net income is computed upon the basis of the accrual method of accounting or for which an election made by the taxpayer under subsection (b) is applicable.

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer * * * but does not include—

* * * * *

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

* * * * *

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, * * *.

* * * * *

(f) *Retirement of Bonds, Etc.*—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

* * * * *

U.S. Treasury Regulations 118 (1939 Code):

§ 39.22(a)–17 *Sale and purchase by corporation of its bonds.* * * * (c) If bonds are issued

by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. * * *

* * * * *

§ 39.42–7 *Short-term obligations issued on discount basis.* In the case of any obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of. Accordingly, if a taxpayer who computes his net income on the accrual basis purchases upon issuance a United States Treasury bill and holds it until maturity, the entire amount of the discount at which the bill was originally sold accrues on the date of maturity; and if such a taxpayer holds a United States Treasury bill for a period less than its life, the portion of the original discount attributable to such period accrues only on the date on which he sells or otherwise disposes of the bill or receives payment at maturity. The original discount or the portion of such discount, as the case may be, is includible only in the gross income for the taxable year in which the taxpayer sells or otherwise disposes of the bill or receives payment at maturity. For examples illustrating rules for computation of income from sale or other disposition of obligations of the type described in this section, see § 39.117(a)–1.

* * * * *

§ 39.117(a)–1 *Meaning of terms.*

* * * * *

(d) Obligations of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, are excluded from the term "capital assets." * * * It is, therefore, not necessary for a taxpayer, other than a life insurance company subject to taxation only on interest, dividends, and rents, to segregate the original discount accrued (see § 39.42–7) and the gain or loss realized upon the sale or other disposition of any such obligation.

Example (1). A (not a life insurance company) buys a $100,000 90-day Treasury bill upon issuance for $99,998. As of the close of the forty-fifth day of the life of such bill, he sells it to B (not a life insurance company) for $99,999.50. The entire net gain to A of $1.50 may be taken into account as a single item of income, without allocating $1 to interest and $0.50 to gain. If B holds the bill until maturity his net gain of $0.50 may similarly be taken into account as a single item of income, without allocating $1 to interest and $0.50 to loss.

Example (2). The facts in this example are the same as in example (1) except that the selling price to B is $99,998.50. The net gain to A of $0.50 may be taken into account without allocating $1 to interest and $0.50 to loss, and, similarly, if B holds the bill until maturity his entire net gain of $1.50 may be taken into account as a single item of income without allocating $1 to interest and $0.50 to gain.

* * * * *

B. Internal Revenue Code of 1954

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

Sec. 1232. Bonds and Other Evidences of Indebtedness.

(a) *General Rule.*—For purposes of this subtitle, in the case of bonds, debentures, notes or certificates or other evidences of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

(1) *Retirement.*—Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

(2) *Sale or exchange.*—

(A) [As amended by Sec. 50(a), Technical Amendments Act of 1958, P.L. 85–866, 72 Stat. 1606] *General rule.*—Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed—

* * * * *

(ii) * * * an amount which bears the same ratio to the original issue discount (as defined in subsection (b)) as the number of complete months that the bond or other evidence of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity,

shall be considered as gain from the sale or exchange of property which is not a capital

asset. Gain in excess of such amount shall be considered gain from the sale or exchange of a capital asset held more than 6 months.

* * * * *

(b) *Definitions.—*

(1) *Original issue discount.*—For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. * * *

* * * * *

U.S. GOVERNMENT PRINTING OFFICE: 1968

In the Supreme Court of the United States

No. 628.
OCTOBER TERM, 1964.

UNITED STATES OF AMERICA,
Petitioner,

vs.

MIDLAND-ROSS CORPORATION,
Respondent.

APPENDIX TO BRIEF FOR RESPONDENT.

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APPENDIX.

INTERNAL REVENUE CODE OF 1939.

Gross Income—Definition.

Sec. 22. (a) General Definition.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly. In the case of judges of courts of the United States who took office on or before June 6, 1932, the compensation received as such shall be included in gross income.

(26 U. S. C. 1952 ed., Sec. 22.)

Sec. 42. Period in Which Items of Gross Income Included.

* * * * *

(b) Noninterest-Bearing Obligations Issued at Discount.—If, in the case of a taxpayer owning any noninterest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals or owning an obligation described in paragraph (2) of subsection (d), the increase in the redemption price of such obligation occurring in the taxable year does not (under the method of accounting used in computing his net in-

come) constitute income to him in such year, such taxpayer may, at his election made in his return for any taxable year beginning after December 31, 1940, treat such increase as income received in such taxable year. If any such election is made with respect to any such obligation, it shall apply also to all such obligations owned by the taxpayer at the beginning of the first taxable year to which it applies and to all such obligations thereafter acquired by him and shall be binding for all subsequent taxable years, unless upon application by the taxpayer the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to change to a different method. In the case of any such obligations owned by the taxpayer at the beginning of the first taxable year to which his election applies, the increase in the redemption price of such obligations occurring between the date of acquisition (or, in the case of an obligation described in paragraph (2) of subsection (d), the date of acquisition of the series E bond involved) and the first day of such taxable year shall also be treated as income received in such taxable year.

(c) Short-Term Obligations Issued on Discount Basis.—In the case of any obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of.

* * * * *

(26 U. S. C. 1952 ed., Sec. 42)

Sec. 111. Determination of Amount of, and Recognition of, Gain or Loss.

(a) Computation of Gain or Loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

(26 U. S. C. 1952 ed., Sec. 111)

Sec. 113. Adjusted Basis For Determining Gain or Loss.

(a) Basis (unadjusted) of Property.—The basis of property shall be the cost of such property; except that—[exceptions not applicable].

* * * * *

(b) Adjusted Basis.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) General Rule.—Property adjustment in respect of the property shall in all cases be made—

* * * * *

(H) in the case of any bond (as defined in section 125) the interest on which is wholly exempt from the tax imposed by this chapter, to the extent of the amortizable bond premium disallowable as a deduction pursuant to section 125 (a) (2), and in the case of any other bond (as defined in such section) to the extent of the deductions allowable pursuant to section 125 (a) (1) with respect thereto.

* * * * *

(26 U. S. C. 1952 ed., Sec. 113)

Sec. 117. Capital Gains and Losses.

(a) Definitions.—As used in this chapter—

(1) Capital Assets.—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

* * * * *

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

* * * * *

(f) Retirement of Bonds, etc.—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

* * * * *

(26 U. S. C. 1952 ed., Sec. 117)

Sec. 125. Amortizable Bond Premium.

(a) General Rule.—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

(1) Interest Wholly Or Partially Taxable.—In the case of a bond (other than a bond the interest on which is excludable from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) Interest Wholly Tax-Exempt.—In the case of any bond the interest on which is excludable from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) Adjustment of Credit in Case of Interest Partially Tax-Exempt.—In the case of any bond the interest on which is allowable as a credit against net income, the credit provided in section 25 (a) (1) or (2), or section 26 (a), as the case may be, shall be reduced by the amount of the amortizable bond premium for the taxable year.

(26 U. S. C. 1952 ed., Sec. 125)

Sec. 201. Life Insurance Companies.

(e) Amortization of Premium and Accrual of Discount.—The gross income, the deduction provided in section 201 (c) (7) (A) and the credit allowed against net income in section 26 (a) shall each be decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a life insurance company. Such amortization and accrual shall be determined (1) in accordance with the method regularly employed by such company, if such method is reasonable, and (2) in all other cases, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary.

* * * * *

(26 U. S. C. 1952 ed., Sec. 201)

Sec. 207. Mutual Insurance Companies Other Than Life or Marine.—

* * * * *

(d) Amortization of Premium and Accrual of Discount.—The gross amount of income during the taxable year from interest, the deduction provided in subsection (b) (4) (A), and the credit allowed against net income in

section 26(a) shall each be decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by this section. Such amortization and accrual shall be determined (1) in accordance with the method regularly employed by such company, if such method is reasonable, and (2) in all other cases, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary.

* * * * *

(26 U. S. C. 1952 ed., Sec. 207)

Sec. 211. Tax on Nonresident Alien Individuals.

* * * * *

(B) Capital gains of aliens temporarily present in the United States.—In the case of a nonresident alien individual not engaged in trade or business in the United States, there shall be levied, collected, and paid for each taxable year, in addition to the tax imposed by subparagraph (A)—

(i) if he is present in the United States for a period or periods aggregating less than ninety days during such taxable year—a tax of 30 per centum of the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected during his presence in the United States exceed his losses, allocable to courses within the United States, from such sales or exchanges effected during such presence; or

(ii) if he is present in the United States for a period or periods aggregating ninety days or more during such taxable year—a tax of 30 per centum of the amount by which his gains, derived from sources within the United States, from sales or exchanges of capital assets effected at any time during such year exceed his losses, allocable

to sources within the United States, from such sales or exchanges effected at any time during such year.

For the purposes of this subparagraph, gains and losses shall be taken into account only if, and to the extent that, they would be recognized and taken into account if such individual were engaged in trade or business in the United States, except that such gains and losses shall be computed without regard to the provisions of section 117 (b) and such losses shall be determined without the benefits of the capital loss carry-over provided in section 117 (e).

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(26 U. S. C. 1952 ed., Sec. 211)

U. S. TREASURY REGULATIONS 118 (1939 CODE).

§ 39.201-1 Tax on Life Insurance Companies.

(b) The net income of life insurance companies differs from the net income of other corporations. See section 201 (c). Life insurance companies are entitled, in computing normal-tax net income and corporation surtax net income, to the credits provided in section 26 in the manner and to the extent provided in sections 13 (a) and 15 (a), respectively. The gross income, the deduction under section 201 (c) (7) (A) for wholly tax-exempt interest, and the credit under section 26 (a) for partially tax-exempt interest, are decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. See section 201 (e) and § 39.201-9. Such companies are not subject to the provisions of section 117 (capital gains and losses) nor to the provisions of section 125 (amortizable bond premium). For computation of the adjusted normal-tax net income from normal-tax net income and the adjusted corporation surtax net income from corporation surtax net income, see §§ 39.202-1, 39.202-2, and 39.203-1. For computation of the 1952 or 1953 adjusted normal-tax net income from the normal-tax net income for such year, see §§ 39.203A-1 and 39.203A-2.

§ 39.207-1(a) Tax on Mutual Insurance Companies other than Life or Marine Fire Insurance Companies Subject to the Tax Imposed by Section 204.

(2) The taxable income of mutual insurance companies subject to the tax imposed by section 207 differs from the taxable income of other corporations. See section 207 (a) (2) and section 207 (b). Such companies are entitled, in computing normal-tax net income and corporation surtax net income, to the credits provided in section 26 in the manner and to the extent provided in sections 13 (a) and 15 (a). The gross amount of income during the taxable year from interest, the deductions under section 207 (b) (4) (A) for wholly tax-exempt interest, and the credit under section 26 (a) for partially tax-exempt interest, are decreased by the appropriate amortization of premiums and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by section 207. See section 207 (d) and § 39.207-6.

INTERNAL REVENUE CODE OF 1954.

Sec. 1232. Bonds and Other Evidences of Indebtedness.

(a) [as amended by Sec. 50 of the Technical Amendments Act of 1958, P. L. 85-866, 72 Stat. 1606] *General Rule.*—For purposes of this subtitle, in the case of bonds, debentures, notes, or certificates or other evidence of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

(1) *Retirement.*—Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

(2) *Sale or Exchange.*—

(A) *General rule.*—Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed—

(i) an amount equal to the original issue discount (as defined in subsection (b)), or

(ii) if at the time of original issue there was no intention to call the bond or other evidence of indebtedness before maturity, an amount which bears the same ratio to the original issue discount (as defined in subsection (b)) as the number of complete months that the bond or other evidence of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity,

shall be considered as gain from the sale or exchange of property which is not a capital asset. Gain in excess of such amount shall be considered gain from the sale or exchange to a capital asset held more than 6 months.

* * * * *

(26 U. S. C. 1958 ed., Sec. 1232)

U. S. TREASURY REGULATIONS (1954 CODE).

§ 1.61-7 Interest.

(c). *Obligations bought at a discount; bonds bought when interest defaulted or accrued.* When notes, bonds, or other certificates of indebtedness are issued by a corporation or the Government at a discount and are later redeemed by the debtor at the face amount, the original discount is interest, except as otherwise provided by law. See also paragraph (b) of this section for the rules relating to Government bonds. If a taxpayer purchases bonds when interest has been defaulted or when the interest has accrued but has not been paid, any interest which is in arrears but has accrued at the time of purchase is not income and is not taxable as interest if subsequently paid.

Such payments are returns of capital which reduce the remaining cost basis. Interest which accrues after the date of purchase, however, is taxable interest income for the year in which received or accrued (depending on the method of accounting used by the taxpayer).

80TH CONGRESS, 2D SESSION H. R. 6999.

IN THE HOUSE OF REPRESENTATIVES

JUNE 19, 1948

Mr. HARDIE SCOTT introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To provide for capital-gain treatment with respect to income received on the redemption of certain United States savings bonds.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That Section 22 of the Internal Revenue Code (relating to gross income) is hereby amended by adding at the end thereof the following new subsection:

"(o) UNITED STATES SAVINGS BONDS ISSUED AT DISCOUNT.—

"(1) INCREMENT IN VALUE.—In the case of United States savings bonds issued on a discount basis on or after March 1, 1941, under section 22 of the Second Liberty Bond Act, as amended, any increment in value represented by the difference between the price paid and the redemption value received or accrued during the taxable year shall be considered, notwithstanding the provisions of section 22 (d) of such Act, as gain from the sale or exchange of a capital asset held for more than six months.

"(2) CROSS-REFERENCE.—For provisions permitting taxpayer reporting on cash basis to treat increase in redemption price occurring in a taxable year as income received in such year, see section 42(b)."

SEC. 2. The amendment made by this Act shall be applicable with respect to taxable years beginning after December 31, 1947.

REPORT OF SUBCOMMITTEE OF COMMITTEE ON WAYS AND MEANS, 75TH CONG. 3RD SESS. DATED JANUARY 14, 1938. REPORTED IN HEARINGS ON H. R. 9682, 75TH CONG. 3RD SESS., p. 38.

It is important also to emphasize that there is no clean separation in practice, between capital gains and ordinary income; and that the complete exemption of capital gains from income taxes might well stimulate the conversion of other types of income into the form of capital gains. For instance, mortgages, land contracts, etc., are frequently sold at substantial discounts. From a statutory standpoint, the difference between the principal amount and the purchase price is regarded as a capital gain; but from an economic standpoint the discount is merely the means whereby the effective annual yield of the instrument is raised from, say, 6 per cent to 12 or 15 percent. A bond purchased at a premium results in a capital loss when redeemed at par, and a bond purchased at a discount, in a capital gain. Yet it is the everyday practice in investment circles to quote both these types of bonds in terms of their effective yields to maturity or call date. Consequently, elaborate provisions in the statute, the effective administration of which would be impossible or extremely difficult, would be necessary, if the income tax were removed from capital gains, in order to prevent widespread avoidance of the income-tax burden through manipulation of ordinary income into the guise of capital gain.

CONGRESSIONAL RECORD—SENATE.
June 4, 1929.

*[p. 2319] AMENDMENT OF SECOND LIBERTY BOND ACT

Mr. Smoot. Mr. President, I ask unanimous consent that the pending unfinished business may be temporarily laid aside and that the Senate proceed to the consideration of the bill (H. R. 1648) to amend section 5 of the second Liberty bond act, as amended. The Senator from Michigan [Mr. Couzens], because of whose absence on a previous occasion the bill was temporarily laid over, is now present.

The President pro tempore. Is there objection to the request of the Senator from Utah?

There being no objection, the Senate, as in Committee of the Whole, proceeded to consider the bill.

Mr. Couzens. Mr. President, the House bill having been substituted for the Senate, and being a short bill, I think it ought to be read, because I think it is of considerable importance.

The President pro tempore. The bill will be read.

The Chief Clerk read the bill, as follows:

Be it enacted, etc., That section 5 of the second Liberty bond act, as amended (U. S. C., title 31, sec. 754), is hereby amended to read as follows:

"Sec. 5. (a) That in addition to the bonds and notes authorized by sections 1 and 18 of this act, as amended, the Secretary of the Treasury is authorized to borrow from time to time, on the credit of the United States, for the purposes of this act, to provide for the purchase or redemption before maturity of any certificates of indebtedness or Treasury bills issued hereunder, and to meet public expenditures authorized by law, such sum or sums as in his judgment may be necessary, and to issue therefor (1) certificates of indebtedness of the United States at not less than par and at such rate or rates of interest, payable at such time or times as he may prescribe; or (2) Treasury bills on a discount basis and payable at maturity without interest. Treasury bills to be issued hereunder shall be offered for sale on a competitive basis, under such regulations and upon such terms and conditions as the Secretary of the Treasury may prescribe, and the decisions of the Secretary in respect of any issue shall be final. Certificates of indebtedness and Treasury bills issued hereunder shall be in such form or forms and subject to such terms and conditions, shall be payable at such time not exceeding one year from the date of issue, and may be redeemable before maturity upon such terms and conditions as the Secretary of the Treasury may prescribe. Treasury bills issued hereunder shall not be acceptable before maturity in payment of interest or of principal on account of obligations of foreign governments held by the United States of

America. The sum of the par value of such certificates and Treasury bills outstanding hereunder and under section 6 of the first Liberty bond act shall not at any one time exceed in the aggregate $10,000,000,000.

"(b) All certificates of indebtedness and Treasury bills issued hereunder (after the date upon which this subdivision becomes law) shall be exempt both as to principal and interest, and any gain from the sale or other disposition thereof shall be exempt from all taxation (except estate or inheritance taxes) now or hereafter imposed by the United States, or by any local taxing authority; and no loss from the sale or other disposition thereof shall be allowed as a deduction or otherwise recognized for the purposes of any tax now or hereafter imposed by the United States or any of its possessions.

"(c) Wherever the words 'bonds and notes of the United States,' or 'bonds and notes of the Government of the United States,' or 'bonds or notes of the United States' are used in the Federal reserve act, as amended, they shall be held to include certificates of indebtedness and Treasury bills issued hereunder."

Mr. Couzens. Mr. President, the Finance Committee considered the bill (S. 310) to amend section 5 of the second Liberty bond act, as amended, for which the pending House bill has been substituted. I think the bill has a great deal of merit, and I approve of all of it substantially, except subsection (b) in section 5, which refers to the exemption from taxation of certificates of indebtedness or Treasury bills. It exempts from taxation all capital gains in transactions relating to them.

All capital gains from transactions in any security are now subject to the income tax. Efforts have been made from time to time, and strenuous efforts are now being made to exempt capital gains from income taxation. The movement is particularly energetic at this time because of the great gains which have been made on the New York Stock Exchange. It may be said that literally hundreds of millions of dollars have been made in transactions on the

stock-exchange. If Congress should adopt the principle of exempting from taxation capital gains, the Government will have its revenue materially cut.

Mr. Smoot. Mr. President, will the Senator from Michigan yield to me?

The Vice President. Does the Senator from Michigan yield to the Senator from Utah?

Mr. Couzens. I yield.

Mr. Smoot. I think the Senator from Michigan will agree with me that there is no inclination whatever, so far as the members of the Finance Committee are concerned, to adopt such a program. I know at this time, as the Senator has stated, that there is pressure being brought to bear from some sources to exempt all capital gains from taxation, but, so far as the Finance Committee is concerned, I do not know of a single member of that committee who would vote for such a proposition.

Mr. Couzens. Mr. President, notwithstanding what the Senator from Utah says, I have been here long enough to know that men change their minds. Under pressure I have known many Senators to change their minds. Minds may be changed now or changed later with respect to the taxation of capital gains.

Mr. Fletcher. Mr. President—

The Vice President. Does the Senator from Michigan yield to the Senator from Florida?

Mr. Couzens. I yield.

Mr. Fletcher. Why should we now exempt the certificates and bills provided for in this bill from capital-gains taxation?

Mr. Couzens. That is the very question I raised in the Finance Committee. I objected then, and I here now object to an entering wedge of any kind which would exempt from taxation capital gains, no matter on what sort of securities they might be made.

[p. 2320] Mr. Smoot. Mr. President—

The Vice President. Does the Senator from Michigan yield further to the Senator from Utah?

Mr. Couzens. I yield.

Mr. Smoot. I think the Senator went even further than that. As I understand the Senator's position is this: He would like to have stricken out the language:

Any gain from the sale or other disposition thereof shall be exempt from all taxation.

Those are the words the Senator desires to be stricken out.

Mr. Couzens. Those are the words to which I particularly object.

Mr. Smoot. As to the bills themselves, and as to the Treasury certificates, they are exempt, and the provision just read by me refers to the gain that may accrue from them. The bill makes no other change, I will say to the Senator.

Mr. Fletcher. That is precisely the point. I think the Senator from Michigan is right about it.

Mr. Couzens. That is precisely the point I make. This is the first attempt to exempt any form of security from capital-gain taxation.

Mr. Edge. Mr. President—

The Vice President. Does the Senator from Michigan yield to the Senator from New Jersey?

Mr. Couzens. I yield.

Mr. Edge. The object is perfectly obvious, is it not, that the bills will bear a rate of interest that much lower?

Mr. Couzens. That argument is a very fallacious one, because the States can come in and claim the same exemption in the case of their securities. In other words, if the capital gain on these bills should be exempted from taxation there is no reason why every other Federal security and State and municipal securities should not have a similar exemption from capital-gain taxation.

Mr. Smoot. Mr. President, will the Senator yield?

The Vice President. Will the Senator from Michigan yield further to the Senator from Utah?

Mr. Couzens. I yield.

Mr. Smoot. I think there is one reason, I will say to the Senator, namely, that these are short-term bills.

Mr. Couzens. Oh, yes.

Mr. Smoot. They would not be issued for longer than three months, and, more than likely, the Treasury would be in a position to take them up within 30 days after they were issued, or, at any rate, within 60 days, and in no event can the period exceed three months.

As Senators know, there are four dates on which income taxes are paid, namely, March 15, June 15, September 15, and December 15. These certificates and bills will be purchased in the market and the proceeds will be used to cover the expenses of the Government so that the Government will not have to issue bonds and will be able to save the amount of interest which would accrue between the time that the certificates or the bills shall be issued and the end of the respective periods when the income-tax payments are due.

Mr. Glass. Mr. President—

The Vice President. Does the Senator from Michigan yield to the Senator from Virginia?

Mr. Couzens. Before I yield to the Senator from Virginia I wish to say that the argument the Senator from Utah is making does not touch the issue at all. There have not been very many occasions when I could commend the Treasury Department, but on this occasion I want to commend that department for suggesting this plan of short-time financing. I think it is a very commendable plan; but I disagree with the feature which has been injected into it and which has nothing whatever to do with the financial scheme properly considered of exempting capital gains from taxation.

Mr. Smoot. The Senator will admit, will he not, that if the bills were exempt so far as capital-gains taxation is concerned, the Government could purchase the money through these bills a little cheaper than it otherwise could?

Mr. Couzens. That may be said with respect to all Federal obligations. Why not exempt them all? I contend that this is merely an entering wedge in an effort to exempt capital gains from taxation. There is no more reason why these Treasury bills should be exempted from capital-gains taxation than that Liberty bonds or other obligations of the Federal Government should be so exempted.

Mr. Glass. Mr. President—

Mr. Smoot. There is only this reason—

The Vice President. Does the Senator from Michigan yield; and if so, to whom?

Mr. Couzens. I yield to the Senator from Utah in order that he may finish what he desires to say.

Mr. Smoot. I say that the only reason is that these are very short-time bills. I agree with the Senator as to the exemption of capital gains in the case of obligations that the Government has already issued and on which capital-gains taxes are paid, and I would not care if the principle were extended further; but, as I have said, the life of the Treasury bills under this measure will not on the average be more than 45 days. They will be sold in the open market, as I have already stated, and the Treasury Department thinks at least—and I rather agree with them—that with this provision in the bill they may be able to obtain money for the short periods of time desired at a little less rate and perhaps make more than would be gained by taxing capital gains which might accrue upon the bills.

Mr. Couzens. I do not agree with the Senator from Utah in that respect. The Federal Government could borrow all the money it needs at a less rate if it exempted capital gains from taxation. It could borrow all of its money at a much less rate if it exempted its securities from all taxation, as State and municipal bonds are exempted.

Mr. Glass. Mr. President.

The Vice President. Does the Senator from Michigan now yield to the Senator from Virginia?

Mr. Couzens. I do.

Mr. Glass. Mr. President, I wish to ask both Senators whether or not the committee considered another aspect of this question which, in my view, is very much more serious than the tax phase of it, and that is the use of these short-time certificates for stock-gambling purposes.

It is a very well-known fact that in this frightful orgy of speculation which has almost paralyzed the legitimate commercial and industrial credits of this country, the speculators have been enabled to operate excessively and

with facility because of a provision of the Federal reserve act that permits direct borrowings by the banks under the 15-day clause of that statute. It is now proposed to issue short-time certificates which will facilitate that sort of activity by the stock gamblers, which will enable them to buy from day to day these short-time certificates and have them rediscounted at the Federal reserve banks, and thus manipulate the credits of the Government in order to increase the credits of the stock gamblers.

Mr. Couzens. Mr. President, I should like to say to the Senator in that connection that I think he has not carefully considered the bill, for the reason that this provision does not provide for additional financing. It simply substitutes a non-interest-bearing certificate for an interest-bearing certificate. In other words, there is no additional financing whatever.

These bills, when sold, will be sold without any interest rate whatever. They will be sold by competitive bidding; and whatever interest the purchaser secures is the difference between the value of the certificate at maturity and the price he pays for it. That is substituted in place of the present short-time certificate issued for 3, 6, or 9 months or a year at an interest rate of 3 or 3½ or 4½ per cent, or whatever the rate may be. It seems to me there is every advantage in substituting this form of financing the Government for the present form.

Mr. Glass. Oh, I concede that that would be so for the Government's operations.

Mr. Couzens. But it makes no difference in the volume.

Mr. Smoot. They have to pay for the certificates.

Mr. Glass. But a speculator can obtain these short-time certificates for use in the rediscount market with greater convenience and facility to himself than he could obtain United States bonds.

Mr. Couzens. Oh, no, no; that is not the question, Mr. President. The Treasury officials are now issuing, as the Senator knows, certificates of indebtedness, and they are available to the speculator in every way.

Mr. Glass. I know they are, and that is what I am complaining of.

Mr. Couzens. These are no different.

Mr. Glass. But here we are multiplying the facilities for that very sort of thing.

Mr. Couzens. Oh, no; the Senator is all wrong in regard to multiplying the facilities.

Mr. Glass. As a matter of fact, we ought to repeal the wartime provision—because it was put there under the pretense that it was a war necessity—of the Federal reserve act that enables these gamblers to use the credit of the United States Government for their purposes.

Mr. Couzens. I have no objection if the Senator will propose that. That, however, is an entirely different proposition than the one we now have before us. If the Senator will introduce a bill proposing the repeal of the section of which he complains, I shall be very glad to support his efforts.

Mr. Glass. I am going to do that.

* * * * *

[There followed a debate on the wisdom of a capital gains tax, the Federal Reserve System and the stock market.]

[p. 2328]. Mr. Couzens. Now we come back to the business before the Senate. On page 3 of the bill subsection (b) reads:

All certificates of indebtedness and Treasury bills issued hereunder (after the date upon which this subdivision becomes law) shall be exempt, both as to principal and interest, and any gain from the sale or other disposition thereof shall be exempt from all taxation.

In line 3, page 4, I move to strike out the words "and any gain from the sale or other disposition thereof shall be exempt from all taxation." I offer that as an amendment to the bill.

I want to say in this connection that to the other features of the bill I have no objection and I believe that the passage of the bill with that exception will save much

money to the Government in its refinancing operation.

Mr. McKellar. Mr. President, may we have the clerk state the amendment?

Mr. Couzens. I will restate it for the Senator. If the Senator will look at page 3 of the bill, in line 4, he will see there the words which I have moved to strike from the bill, as follows:

and any gain from the sale or the disposition thereof shall be exempt from all taxation.

If those words are stricken from the bill, so far as I am concerned, the bill is all right.

[p. 2329]. The Vice President. May the Chair call the Senator's attention to the fact that the words "from all taxation" in line 5 applied to the words preceding those which the Senator desires to strike out?

Mr. Couzens. The present bonds are all tax exempt. There are other bonds that have been issued that are tax exempt in limited amounts. As respects those matters I do not particularly object to them being tax exempt so far as anything is concerned except the capital gain. In other words, I have no objection to the Federal bonds being exempt from taxation to the same extent that State and municipal bonds are exempt. I will support any other amendment that anybody else chooses to offer in that connection, but I believe that Federal bonds should be on the same basis as State and municipal bonds. I confess to the fact that the Chair is right, that this is a diversion from the usual principle of taxing these bonds.

The Vice President. The question is on agreeing to the amendment submitted by the Senator from Michigan.

Mr. Smoot. Mr. President, the Treasury Department is very anxious that those words remain in the bill. That part of the bill is one which was perhaps most discussed before the committee. The committee as a whole, with the exception of the Senator from Michigan, thought that it was the proper thing to leave those words in the bill. Instead of costing the Government any money it will, in my opinion, save the Government thousands and tens of thousands of dollars. However, I want the Senate to ex-

press its opinion and I have no objection to a vote upon the item, if the Senators wants the yeas and nays.

Mr. Couzens. I want to make one exception to what the Senator from Utah just said. The Senator said the Treasury Department was exceedingly anxious to have that language retained in the bill. Mr. Ogden Mills did not strenuously urge that the language be retained in the bill because it was pointed out that bills of acceptance and other financial transactions in the market do have to pay a capital-gain tax and it was pointed out there was no more intricacy involved in these cases than in this case. There is no urgency on the part of the Treasury Department, so far as it was represented by Mr. Mills before the committee, that the specific language be retained in the bill.

Mr. Smoot. There is no question in my mind but what the administration of the collection of the tax is just as simple on this as on any other bond or certificate issued by the Government of the United States. That question is not involved. The only question for the Senate to decide is whether it would be money in the pockets of the Government to sell these bills with an average life of not to exceed 45 days tax exempt from the gains that may be made upon them, or whether it shall sell them and then let the profits that are made upon them be exempt from taxation. That is all there is to it. It is only a matter of opinion. I hope the Senate will take a yea-and-nay vote on it.

Mr. Couzens. Of course, the Senator is only making an assumption when he says 45 days.

Mr. Smoot: I used what I believe to be the average.

Mr. Couzens. That is not the question. It may be a much longer period than 45 days.

Mr. Smoot. It could not be unless we increased the amount of our obligations. If the Government of the United States got into a position whereby we had to increase our obligations over what they are to-day, then I could not say that; but we know that as long as there is a decrease every year in the outstanding obligations of the

Government, the certificates will be less each year and the life of them would be only between the sale date and the end of the three months. I took the average. It may be 50 days, or it may be 60 days, or it may be 40 days.

Mr. Couzens: Does not the Senator agree that there is now an effort under way to have Congress repeal all of the capital-gain tax?

Mr. Smoot. That has been true ever since we passed the first bill imposing a tax upon capital gains. The Senator is right, but there is no inclination on the part of the Finance Committee of the Senate or the Ways and Means Committee of the House to do such a thing. There is propaganda to have us do so and I am perfectly aware of it, and it will be kept up as long as anyone is compelled to pay that tax; but, in my opinion, the day will not come when Congress will act favorably on any such propaganda.

Mr. Couzens. Is it not true that the Treasury Department on several occasions recommended the repeal of the capital-gains tax?

Mr. Smoot. I think there were two occasions in our hearings when the question arose, and there was an expression on the part of some of the members of the Treasury Department to the effect that if that were done the Government of the United States would lose no money.

Mr. Couzens. If that entering wedge is permitted to become effective to exempt any form of security from capital-gains tax, every Senator knows that it will be used as an argument by every agency that desires a repeal of the capital-gain tax.

Mr. Smoot. It would have no effect whatever on anybody who knew the workings in the department. These bills are not to draw interest. They are to be bought outright. If anyone did buy these bills at 99⅞, we will say, and sold them at 100, there would be that profit of one-eighth. Whether they can do it or not depends entirely upon the money market. I think it is unnecessary, but I am not going to make any special fight over it.

Mr. Reed. Mr. President—

The Vice President. Does the Senator from Utah yield to the Senator from Pennsylvania?

Mr. Smoot. I yield.

Mr. Reed. I think we ought to bear in mind that at the present time all of these certificates of indebtedness and Liberty bonds are absolutely tax free in the hands of the corporations—

Mr. Couzens. Not as to capital gain.

Mr. Reed. Wait a minute. The interest on certificates of indebtedness, on Treasury notes, and on Liberty bonds is absolutely tax free when they are held by a corporation.

Mr. Smoot. That is true.

Mr. Reed. If the Treasury wants to issue $100,000 of 4 per cent certificates with coupons attached for the payment of the interest, no bank or corporation that holds those notes—and most of them are held by corporations—is subject to one penny of tax thereon. The Treasury bills are intended to take the place of short-term Treasury certificates. In order to prevent the necessity of selling them at a flat price fixed in advance by the Treasury, or somewhat under the market in order to make sure they will sell, the Treasury has invented this idea of Treasury bills, somewhat similar to those now used in Great Britain by the Exchequer, in which they sell non-interest-bearing bills at a discount, exactly the same as a bank discounts a 30-day note which is payable at the end of 30 days without any interest. There is an apparent capital gain when a bank buys a 30-day note at a discount, but actually that capital gain represents the hire of the money for the interval that elapses between the purchase and the maturity date.

Mr. Couzens. The Senator has made two statements—

Mr. Reed. I have made more than that.

Mr. Couzens. I know he has made many more than that, but he has made two statements which I am afraid are misleading. In the first place, he said that certifictaes of indebtedness and Federal bonds held by corporations and banks are nontaxable.

Mr. Reed. The interest on them is nontaxable. That is correct.

Mr. Couzens. We are not discussing interest. We are discussing capital gain. The inference goes out that the bonds are not taxable in the hands of corporations. I contend that if there is a capital gain, they are taxable in the hands of a corporation.

Mr. Reed. Precisely; and there the Senator puts his finger on the difference. If there is a capital gain in a transaction involving a 4¼ per cent Liberty bond, that is a true capital gain, and it is not interest. The coupon represents the interest on that investment. These certificates are to have no coupons, and ordinarily the capital gain in the five or six weeks that they would be held would represent the interest. It is the hire for the use of the money.

Mr. Couzens. Before the Senator proceeds further, I want to correct him in one respect. The Senator creates the impression that there can be no capital gain because it is all interest. If I buy one of those bills due September 1, 1929, and I buy it at 98 and sell it to-morrow at 99, there is a capital gain not represented by the interest to which the Senator has referred.

Mr. Reed. Of course there is.

Mr. Couzens. I say the statement is misleading because it is not all interest. It depends upon the time that elapses between the issuance of the security and the date of maturity.

Mr. Reed. If the Senator wants to imagine such an extravagant illustration as that a Treasury bill will appreciate 1 point in the course of a day or a week even, of course in such an illustration there is a capital gain in excess of the amount of the interest paid for the use of the money. But if the Senator will bear with me for a moment, I want to show what the effect of the amendment would be.

This would be the practical effect of the amendment: I personally do not care a rap whether the tax-exempt feature remains in the bill or not; but if we are going to make interest on Treasury certificates tax exempt—and that is what we have [p. 2330] done, because no corporation pays a penny of tax on certificate coupons—then there

is no sense in providing for Treasury bills at all. If a corporation knows that it is going to have to pay a tax on the amount of the discount at which it purchases the Treasury bills under par—whether we regard it as a capital gain, as my friend from Michigan does, or whether we regard it as the hire of the money, as I do, does not make a particle of difference—no bank is going to buy Treasury bills on the same interest basis on which it will buy Treasury certificates, because one is free from tax and the other is subject to 11 per cent tax on all that gain. So there would be no use of initiating the system of Treasury bills if we are going to tax the fractional appreciation in the value. Banks will not buy them or else they will buy them at a discount, which is that much greater, so as to take care of the tax. We are just beating the devil around the bush if we try to make that fraction taxable because we have to pay it to the bank, and then we go and tax the bank and get it back to ourselves. We had better get the advantage of the lower discount rate.

The Vice President. The question is on agreeing to the amendment proposed by the Senator from Michigan [Mr. Couzens].

Mr. Couzens. Mr. President, I wish to answer the Senator from Pennsylvania [Mr. Reed]. He is a very plausible debater, and what he says is substantially correct, except that to eliminate this provision would not defeat the purposes of the Treasury Department. All of the advantages that the Treasury Department would get under this proposed law will still be retained, even with the amendment which I propose, except a possible slight difference in the interest rate because of the fact that the banks may have to pay on the capital gain; but that is all problematical. The Undersecretary of the Treasury stated before the Finance Committee that the same identical bills of indebtedness, when traded in commerce, are subject to a profit tax. When a bill is traded in commerce, an acceptance, or what not, if there is a capital gain, it is taxed. There is no difference whatever. Whether or not we take the money out of one pocket and put it into the other, the

fact is that if we shall adopt the principle of exempting securities from the capital-gain tax we shall establish a principle which will return to plague us so long as we have the capital-gain tax on the statute books.

Mr. Reed. Is there not this distinction: When we tax a bank on the amount it receives in discounting John Smith's 30-day note we are getting the money either from the borrower or the lender; the Government does not pay out the money and immediately get it back, but in this case the Government is the borrower, the maker of the note, and, therefore, I do not see any sense in paying out extra interest and immediately taking back the same money in additional taxes?

Mr. Couzens. In that event why should we not make all of the Government securities exempt from the capital-gain taxation? In other words, if the Government is selling certificates of indebtedness or Federal bonds on which there are no taxes on capital gains, unquestionably we could get a better price for them.

Mr. Reed. If I had my way, there would not be any tax-exempt bonds at all. The Senator from Michigan asked me that question; but that is not practicable now, because we have put that law into effect and can not repeal it without breach of faith. However, so long as we have a great mass of $17,000,000,000 of outstanding securities, the interest on which is tax exempt, in the hands of corporations, and if we desire the securities to be issued under this bill to compete with the others and sell on the same interest basis, we have got to give them the same privilege.

Mr. Couzens. If the Senator is correct, there is not any reason why we can not repeal the law which makes the income on other Federal securities taxable.

Mr. Reed. The Senator does not mean that we can tax Liberty 3½ per cent bonds, for example?

Mr. Couzens. No; I am saying just the reverse. I am saying that there is nothing in the world to prevent Congress from repealing the law which makes other Federal bonds taxable; I do not mean the tax-exempt bonds, but those that are taxable.

Mr. Reed. Yes; there is. If we issued all our Liberty bonds and Treasury notes and Treasury certificates—

Mr. Couzens. And they are all taxable.

Mr. Reed. With the stipulation that they shall be wholly exempt from the normal tax.

Mr. Couzens. I am not talking about the normal tax.

Mr. Reed. The normal tax is all a corporation pays.

Mr. Couzens. I am talking about capital gains. If it is desired to exempt these securities from the capital-gain tax, why not exempt all other Federal securities from the capital-gain tax?

Mr. Reed. Because what the Senator calls capital gain here is really the hire of money; and that is not true of the others; they carry coupons.

Mr. Couzens. But the principle is exactly the same. If there was not an advantage in having the capital-gain tax provision not apply to these securities, it certainly would not be included in the bill. The Senator from Pennsylvania shakes his head, but why does he want this provision in the bill if there is not some advantage to the Government from it?

Mr. Reed. The advantage to the Government is obvious. It is going to have to pay 11 per cent more interest in the way of discount on these bills unless it makes them tax exempt.

Mr. Couzens. So, for the purpose of getting this saving immediately to the Government, the Senator would adopt the principle of waiving the tax on capital gains?

Mr. Reed. Not at all; I am not in favor of waiving the tax on capital gains. In the present condition of affairs it can not fairly be done. I did think a few years ago that the Government would save a great deal of money if it would disregard capital gains and losses, because there were always more losses reported than there were gains. That has not been so since 1924, and I join with the Senator in opposing the repeal of the capital-gains tax now, although I do think that, as it stands, it is a very clumsily arranged tax; it can be improved; but I agree with the Senator that the principle of taxing capital gains must be maintained for many years yet to come.

Mr. Walsh of Montana. Mr. President, I can not believe that the clause in question in this bill relates to such a condition as that suggested by the Senator from Pennsylvania. Of course, if the Treasury discounts its bills the same as the private individual discounts his bills at a bank, the difference between the amount that he pays for the bill and the par value of it is unquestionably the interest which comes to him. I apprehend that no one wants to subject that interest—that is to say, that difference—to taxation; but here is a man who buys one of these bills in a tight market, occasioned, perhaps, by the draining of available funds into the gambling market of which we have been speaking, so that the Government is obliged to sell at a rather high discount. After a time, however, the situation eases and that man sells his bill to someone else and makes a gain on it. I take it that the provision of the bill which the Senator from Michigan seeks to excise refers to gains made by him upon the sale of that bill.

Mr. Reed. That is what the Senator has been speaking of.

Mr. Walsh of Montana. Just as one who bought stock at a certain figure and subsequently sold it at an appreciation would be obliged to include in his income-tax return whatever he made by the sale of the stock, why should he not be obliged to return what he made by speculating in the Government's bills, just as he would be speculating or investing in any other bills?

Mr. Reed. If the Senator will look at the opposite page of the bill he will see that the new matter which it contains is the provision in line 6, on page 2, which provides that Treasury bills may be issued on a discount basis.

Mr. Smoot. Without interest.

Mr. Reed. It is to prevent that discount being taxable that the words were inserted on page 3 which the Senator from Michigan is now trying to strike out.

Mr. Walsh of Montana. I do not think they are nontaxable for that reason at all. They are nontaxable, it seems to me, by reason of the further provision which

forbids the taxing of the interest, because, as I have indicated, in my judgment, the difference between the sale price and the par value of the bill is not a gain from the sale at all but is the actual interest upon the money which is turned into the Treasury.

Mr. Reed and Mr. Couzens addressed the Chair.

The Vice President. Does the Senator from Montana yield; and if so, to whom?

Mr. Walsh of Montana. Just a moment. Is it not always the case with a bill which is discounted at a bank that the difference between the amount realized by the maker of the bill and the face of the bill is what he pays in interest?

Mr. Reed. Yes; and that is what I have been arguing.

Mr. Walsh of Montana. Exactly.

Mr. Reed. And it is to make that difference nontaxable that these words were put in.

Mr. Walsh of Montana. It is nontaxable by reason of the provision of the bill that—

All certificates of indebtedness and Treasury bills issued hereunder * * * shall be exempt, both as to principal and interest.

That is the whole thing—the principal is exempt. If a man buys at a discount of 4 per cent, he pays 96 for every $100 of face value; he pays $96, which is his principal, and the difference between that and $100 is his interest. He does not pay upon the $96 and he does not pay upon the $4 if he gets it; [p. 2331] but if in the meantime he sells the bill to someone at 99, having paid only 96, then he makes a profit of 3 per cent; and why should he not be taxed on it?

Mr. Reed. Suppose he has held it for three-quarters of its life and sells it at 99?

Mr. Walsh of Montana. Very well. He will then take credit for three-quarters of 4 per cent.

Mr. Reed. That is the businesslike way of doing it; but under the present regulations of the Bureau of Internal Revenue the whole amount would be considered to be capital gain.

Mr. Walsh of Montana. It is a very easy thing to figure out how much of the appreciation is interest upon his investment and how much is actual gain by reason of the sale.

Mr. Smoot. Mr. President—

Mr. Couzens. Mr. President, will the Senator yield?

The Vice President. Does the Senator from Montana yield; and if so, to whom?

Mr. Walsh of Montana. I yield first to the Senator from Utah.

Mr. Smoot. Mr. President, the theory of the bill is that if the bills are tax exempt, the Government of the United States can make more out of their sale because of a lesser rate of interest than it can by taxing capital gain if a profit should be made. No interest is involved in it at all; there is no interest to be collected on the bills; they are sold without interest; and the Secretary of the Treasury believes that with the words which have been referred to in the bill the Government will get more for the securities than if it imposed a tax upon whatever the interest might be.

Mr. Walsh of Montana. I understand that perfectly well; but if I discount a bill for $100 at the bank, and I get only $96, I am paying 4 per cent interest, or substantially 4 per cent; and the difference between the $96 and the $100 is interest. It can not be designated in any other way, and that is the way it is understood. So when the Treasury discounts its bills at 4 per cent, that 4 per cent represents the interest which the Government pays.

If the interest is exempt, as provided in the bill, and the principal is exempt, as provided in the bill, if the purchaser of the bill sells it meanwhile, and makes a profit on his sale, why should not that profit be taxable just the same as the profit he makes on the sale of stocks or anything else?

Mr. Couzens. Mr. President, if the Senator will yield to me, is not this a simple illustration? If the Government sells to you a $1,000 bond or certificate of indebtedness on a 4 per cent basis, and you turn around and sell it on a 3 per cent basis, the difference is profit.

Mr. Walsh of Montana. Unquestionably.

Mr. Couzens. That is the simple way of putting it. In other words, if the Government sells the certificate to one individual on a 4 per cent basis, and he turns around and sells it on a 3 per cent or 2 per cent basis, the difference is profit.

Mr. Walsh of Montana. Exactly. I want 4 per cent on my money, and I buy the bill; but I find someone who is perfectly content with 2½ per cent, and he will offer me a premium for it.

Mr. Reed. Mr. President, it seems to me these questions have brought the issue down to the real point. What actually happens in the case of the transaction described by the Senator from Montana is that a negotiable instrument is bought at one price, and subsequently sold at another; and the profit, taken in connection with the time the bill is held, is a capital gain which is the equivalent of interest on that money.

Mr. Couzens. Oh, no!

Mr. Reed. It is just a matter of definition. Please indulge me until I finish the thought. Now, if we can agree that the amount of the discount at which the bill was originally sold shall be considered as interest, and that that shall be nontaxable, while at the same time any transactions relating in capital gains pending the maturity of the certificate should be taxed, I think we should all be agreed on the situation. All the Treasury wants is to make that which is in good faith the equivalent of interest tax free, as it is to-day on Treasury certificates; and I understand that the Senator has no objection to that.

Mr. Walsh of Montana. Not at all. We are agreed about what ought to be done. It is simply a question as to the language in which our views ought to be expressed.

Mr. Reed. It is merely a matter of expressing that thought clearly; and we ought to be able to agree on that.

* * * * *

[There followed a discussion of the new Treasury bills and of tax free exchanges.]

[p. 2332] Mr. Couzens. I think we have practically reached an agreement as to language which may be substituted for subsection (h). I will send it to the desk, if the Senator will permit, and have it read.

Mr. McKellar. I am happy to know the Senator has been successful in that.

Mr. Couzens. I think we have arrived at an agreement on language which will suit everybody.

Mr. Smoot. The language is perfectly satisfactory to me.

Mr. McKellar. Let the clerk read it.

The Vice President. The clerk will read the amendment.

The Legislative Clerk. On page 3, to strike out lines 1 to 11, inclusive, and insert in lieu thereof the following:

[p. 2333] (b) All certificates of indebtedness and Treasury bills issued hereunder (after the date upon which this subdivision becomes law) shall be exempt, both as to principal and interest, from all taxation (except estate and inheritance taxes) now or hereafter imposed by the United States or by any local taxing authority; and the amount of discount at which Treasury bills are originally sold by the United States shall be considered to be interest within the meaning of this subdivision.

Mr. McKellar. I am of the opinion that that will correct the situation.

Mr. Couzens. That accomplishes the purpose we have been trying to accomplish.

Mr. McKellar. I think so.

Mr. Couzens. It leaves out all reference to capital gains, so that if a security sold by the United States is held to maturity, the gain is considered as interest, and is, therefore, under the law, tax exempt, but if there is any transaction in the particular note or security afterwards in which the interest rate changes, or in which there is a gain, that gain is taxable under the existing law. To offset that, we had to eliminate from the bill reference to the deduction of losses.

Mr. Smoot. I have no objection.

The Vice President. Does the Senator from Michigan withdraw his other amendment?

Mr. Couzens. I withdraw that, and offer this as a substitute.

* * * * *

The Vice President. The question is on agreeing to the amendment offered by the Senator from Michigan.

The amendment was agreed to.

The bill was reported to the Senate as amended, and the amendment was concurred in.

The amendment was ordered to be engrossed and the bill to be read a third time.

The bill was read the third time and passed.

SPECIAL RULING—1948.

" 'Further reference is made to your letter dated May 19, 1948, in regard to the treatment for income tax purposes of the increment on non-interest bearing bonds.

" 'You refer to section 117(f) of Chapter I of the Internal Revenue Code, which provides, "For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor." Since a gain upon the retirement of a security as described in this section would be subject to tax as a gain on the sale of a capital asset, provided the security itself is a capital asset, you inquire whether the effect of the section is to discriminate against purchasers of United States Treasury savings bonds, the increment of which is subject to surtaxes under the provisions of section 42(b) of the Internal Revenue Code.

" 'Section 22(d) of the Second Liberty Bond Act (c. 56, 40 Stat. 290), as amended by the Public Debt Act of 1941 (c. 7, 55 Stat. 7), relating to United States savings bonds and United States Treasury savings certificates, provides,

in part, "For purposes of taxation any increment in value represented by the difference between the price paid and the redemption value received (whether at or before maturity) for savings bonds and savings certificates shall be considered as interest." In accordance with this specific provision of law, any increment in value of these securities is not subject to the treatment authorized in the case of certain other securities by section 117(f) of the Internal Revenue Code.

" 'The difference in the treatment for income tax purposes of non-interest-bearing securities issued at a discount by private corporations and similar securities issued by the Government has been recognized by the courts. See George Peck Caulkins v. Commissioner (CCH Dec. 13,000), 1 T. C. 65 (6), affirmed by the United States Circuit Court of Appeals for the Sixth Circuit (44-2 USTC Par. 9416) 144 F. (2d) 482.' " Quoted at 26 *taxes* 775-776 (1948.)

SPECIAL RULING, AUGUST 7, 1952.

[Following is the text of a letter to the Commissioner requesting a ruling and the text of a letter dated August 7, 1952, in answer thereto, and signed by E. I. McLarney, Deputy Commissioner (symbols, IT:RP:TR—APK-6)]. The letters were distributed by the Committee of Banking Institutions on Taxation, New York, N. Y.

[Request for Rulings]

We are in receipt of an inquiry concerning the taxation of, and withholding from the income, profits, gains, etc., attributable to:

Bankers' Acceptances,
Commercial Paper, and
U. S. Treasury Discount Bills

when owned by nonresident alien entities not engaged in trade or business in the United States. The phrase "nonresident alien entities" herein referred to means nonresident alien individuals, nonresident partnerships com-

posed in whole or in part of nonresident aliens, and non-resident foreign corporations.

In order that we may properly inform our customers and also that we may properly perform our duties as with-holding agent, we desire information concerning the situations outlined below:

Bankers' Acceptances and Commercial Paper Originally Issued at a Discount

Reference is made to rulings contained in *O. 1024* (C. B. 2, 189) and *I. T. 1398* (C. B. I-2, 149) with respect to Bankers' Acceptances. Such rulings state the following principles:

> The excess of the proceeds (face value) of bankers' acceptances at maturity over their cost to the holder at maturity is not interest.
>
> Gains and profits derived from purchase and sale of bankers' acceptances are not fixed or determinable, annual or periodical income and consequently are not subject to the withholding of Federal Income Tax at source.

Are we correct in drawing the following conclusions in regard to Bankers' Acceptances and Commercial Paper:

> (1) The excess of the proceeds (face value) at maturity over its cost to the holder is not interest, nor is it fixed or determinable annual or periodical income. Therefore, such excess is not subject to the withholding of Federal Income Tax at source, nor does it constitute taxable income.
>
> (2) The foregoing Paragraph (1) holds true at maturity irrespective of the date of acquisition or the price paid.
>
> (3) Any excess over purchase price from sale before maturity is not interest, nor is it fixed or determinable, annual or periodical income. Therefore, such gain is not subject to the withholding of Federal Income Tax at source, nor does it constitute taxable income.

(4) The foregoing Paragraph (3) holds true irrespective of the date of acquisition or of the price paid.

We are aware of the status of income from Bankers' Acceptances owned by a foreign central bank of issue and are not here interested in this particular situation.

[The ruling requested relative to the status of income derived for bankers' acceptances and commercial paper by nonresident alien entities is reported at 525 CCH ¶ 6161. —CCH.]

U. S. Treasury Bills Issued at a Discount

For the purpose of illustration let us assume the following facts:

A $100,000 Treasury Bill is issued at a discount of $378 on February 4, 1952 and matures on May 4, 1952.

Valuation Date	*Thirty Days' Increment*	*Incremented Value*
Feb. 4, 1952	—	$ 99,622
Mar. 5, 1952	$126	99,748
Apr. 4, 1952	126	99,874
May 4, 1952	126	100,000
	$378	

Let us further assume that a nonresident alien entity (as referred to on page 1 of this letter) enters the following transactions through its American custodian (a New York bank):

(1) Purchases the Bill on February 4, 1952 at $99,622 and holds the Bill to maturity when it is redeemed for $100,000. Are we correct in assuming that the entire increment of $378 is taxable income and is subject to withholding by the American custodian?

(2) Purchases the Bill on February 4, 1952 for $99,622 and sells on March 5, 1952 for $99.748. Are

we correct in assuming that the increment of $126 is taxable income but is not subject to withholding by the American custodian?

(3) Purchases the Bill on February 4, 1952 for $99,622 and sells on March 5, 1952 for $99,750. Are we correct in assuming that of the $128 gain involved, $126 is taxable income but is not subject to withholding?

(4) Purchases the Bill on February 4, 1952 for $99,622 and sells on March 5, 1952 for $99,740. Are we correct in assuming that whereas the gain was only $118, the taxable income is $126 but no withholding is required on the latter amount?

(5) Purchases the Bill on March 5, 1952 at $99,748 and holds to maturity. Are we correct in assuming that increment of $252 is taxable income but that withholding will be required on $378?

(6) Purchases the Bill on March 5, 1952 for $99,800 and holds to maturity. Are we correct in assuming that whereas the gain involved is $200, the taxable income is $252 but that withholding is required on $378?

(7) Purchases the Bill on March 5, 1952 at $99,748 and sells on April 4, 1952 for $99,874. Are we correct in assuming that the increment of $126 is taxable but is not subject to withholding?

The foregoing questions have been propounded and the assumed answers are predicated on the theory that the original discount (increment) on U. S. Treasury Discount Bills, issued on and after March 1, 1941, constitutes interest under Subsection 754 (b), Title 31, of the United States Code. Moreover, since such discount (increment) constitutes Interest, it is therefore income as defined under Internal Revenue Code Section 211 (a) and 231 (a). It has also been assumed that U. S. Treasury Discount Bills have but one Interest Date which is at maturity. Consequently, if a Bill is sold before maturity, no withholding is required under Internal Revenue Code Section 143.

It has been further assumed that any gains, profits, losses, etc. resulting from the purchase and sale of U. S. Treasury Discount Bills, at values at variance with the Incremented Values (see page 2), do not affect gross income from sources within the United States when realized by nonresident alien entities not engaged in trade or business in the United States.

While we are cognizant of the many demands made upon you, we should deeply appreciate your prompt consideration of the matters contained herein.

Very truly yours.
(Signed)
X Bank

[Bureau's Ruling]

Reference is made to that portion of your letter of February 5, 1952 relating to the status, for Federal income tax purposes, of income derived from United States Treasury bills by nonresident alien individuals, nonresident partnerships composed in whole or in part of nonresident aliens, and nonresident foreign corporations.

This office is in agreement with the assumptions relative to the taxable status of and the withholding of tax from interest on Treasury bills as set forth in the examples numbered 1 through 7 in your letter. However, in any case where the withholding agent has definite knowledge of the actual amount representing interest income to a nonresident alien entity, he may, at his option, withhold the tax under section 143 (b) or 144 of the Internal Revenue Code only from such amount.

Also, the assumptions that the original discount on Treasury bills constitutes interest income, that such bills have but one interest date, the date of maturity, and that gains, profits, losses, etc., resulting from the sale of Treasury bills do not affect gross income from sources within the United States when realized by nonresident alien entities not engaged in trade or business within the United States are correct.

SPECIAL RULING, MARCH 12, 1952.

[Following is the text of a letter dated March 12, 1952, distributed by the Committee of Banking Institutions on Taxation, New York, N. Y., and signed by E. I. McLarney, Deputy Commissioner (symbols, IT: RP: TR—APK-6):]

Reference is made to your letter of February 5, 1952, wherein information is requested with respect to the status for Federal income tax purposes of income derived from bankers' acceptances, commercial paper, and United States Treasury Bills by nonresident alien individuals, nonresident partnerships composed in whole or in part of nonresident aliens, and nonresident foreign corporations, not engaged in trade or business within the United States.

You refer to *O. 1024,* C. B. 2, 189, and *I. T. 1398,* C. B. 1-2, 149, and ask whether your conclusions are correct that the excess of the proceeds (face value) of bankers' acceptances and commercial paper at maturity over cost to the holder is not interest nor fixed or determinable annual or periodical income irrespective of the date of acquisition or the price paid; and that any excess over the purchase price thereof from sale prior to maturity is not interest nor fixed or determinable annual or periodical income irrespective of the date acquired or the cost.

The conclusions stated above are generally in accord with the position of the Bureau.

The excess of the proceeds of bankers' acceptances and commercial paper at maturity over cost to the holder is not taxable in the hands of nonresident alien individuals not engaged in trade or business in the United States at any time during the taxable year or to nonresident foreign corporations and no withholding of tax is required with respect thereto under section 143(b) or 144 of the Internal Revenue Code. Such excess is also not subject to the withholding of tax when paid to a nonresident partnership composed in whole or in part of nonresident alien individuals. However, the excess over the purchase price of bankers' acceptances and commercial paper from sale prior to maturity although not taxable to a nonresident foreign

corporation and not subject to the withholding of tax, may under section 211(a)(1)(B) as amended by section 213 of the Revenue Act of 1950 be taxable to nonresident alien individuals, even though they are not engaged in trade or business within the United States.

No opinion is being expressed at this time as to the assumptions in your letter relating to Treasury bills issued at a discount as this matter is, at present, being reconsidered by the Office of the Chief Counsel. You will be advised with respect thereto in a later communication from this office.

In the Supreme Court of the United States

No. 628.
OCTOBER TERM, 1964.

UNITED STATES OF AMERICA,
Petitioner,

vs.

MIDLAND-ROSS CORPORATION,
Respondent.

BRIEF FOR RESPONDENT.

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In the Supreme Court of the United States

No. 628.

OCTOBER TERM, 1964.

UNITED STATES OF AMERICA,
Petitioner,

vs.

MIDLAND-ROSS CORPORATION,
Respondent.

BRIEF FOR RESPONDENT.

QUESTION PRESENTED.

Whether Congress intended that difference between face value and the price at which an investor purchased a debt obligation from the debtor should be taxed upon realization by sale as capital gain or instead as if it were interest.

STATUTES INVOLVED.

The relevant statutes and regulations are set forth in the appendix, pages 1a-10a, *infra*.

STATEMENT.

Respondent is the successor by merger to Industrial Rayon Corporation (Industrial) (R. 17).[1] During 1952, 1953 and 1954 Industrial, following a long practice (R. 17), used its excess funds to acquire various non-interest bearing corporate notes of the type commonly used for financ-

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[1] "R." references are to the Transcript of Record. "Br." references are to the Government's Brief.

ing by General Motors Acceptance Corporation, Commercial Investment Trust Co. and Commercial Credit Co. at less than their face value (i.e., at a discount) (R. 13-15). Each of the notes was sold prior to maturity at a profit which aggregated $282,763 (R. 13-15). Industrial reported these profits as capital gain, partly long-term and partly short-term (R. 27). The Internal Revenue Service asserted a deficiency on the ground that the profit should be taxed as ordinary income. Industrial paid the applicable tax and instituted this action for its refund.

There is no contention that the discount at which the notes were purchased was, as a factual matter, interest in disguise. On the contrary, it is stipulated that there was no interest (R. 13-15) and that Industrial realized gains from the sale of capital assets (R. 16).

Under the law which has been in effect since December 31, 1954, the profit would be taxed as ordinary income.[2] However, the transactions involved here occurred prior to the change in the law, so that respondent contends, and the lower courts held, that the profit should be taxed as capital gain.

[2] Section 1232(a)(2), Internal Revenue Code of 1954. All references to the Internal Revenue Code of 1939 will be cited I. R. C. of 1939. All references to the present Internal Revenue Code (Title 26 U. S. C.) will be cited I. R. C.

SUMMARY OF ARGUMENT.

The narrow issue presented by this case is the tax treatment of the appreciation in value during the period of the taxpayer's ownership of a corporate debt instrument purchased below face value. The general rule is that appreciation in value of an asset due to the passage of time does not result in income until the sale of the asset when the income resulting from such appreciation is taxed at capital gain rates if the statutory requirements are met. The Government here is attempting to establish an exception to this rule in the case of a debt obligation originally issued by the debtor at a price below face value. By the terms of the statutes applicable to the years involved in this case the gain was a capital gain.

Under § 1232 I. R. C. the discount below face value at which a corporate debt is purchased is taxed under specified circumstances as ordinary income when the obligation is sold, but this provision is expressly applicable only to obligations issued after December 31, 1954 and does not apply to this case.[3] The Government's attempt to tax this profit as if it were interest is, in effect, an attempt to apply the later statute retroactively.

There is abundant and clear legislative history demonstrating that Congress intended that the discount at which debt obligations are purchased should be reflected only in capital gain or loss at the time of sale. The Senate showed this understanding in 1929 when it enacted a statute requiring a different result for United States obligations. A subcommittee of the House of Representatives showed

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[3] Although one special type of discount was treated as ordinary income to all taxpayers and all such discount was treated as ordinary income to insurance companies under the Internal Revenue Code of 1939, no such exception applies to this case, and the profit is a capital gain under the statute.

the same clear intention in 1938 when it was considering the general revision of the income tax law which became the Internal Revenue Code of 1939. Again in 1954 when it was considering § 1232 I. R. C. which changed the result prospectively, the Ways and Means Committee of the House of Representatives stated that profit attributable to the purchase of a debt obligation at a discount was taxed at capital gains rates.

Throughout the history of the Internal Revenue laws until 1953 the Treasury agreed with the capital gain result and expressly stated in a number of rulings that the discount at which obligations were originally issued resulted in capital gain at the time of sale. In 1953, shortly prior to the enactment of § 1232 I. R. C., the Internal Revenue Service reversed its position in a ruling which has been severely criticized,[4] Rev. Rul. 119, 1953-2, Cum. Bull. 95.

The Government's comparison between the purchase of a note for $100 promising to pay $100 plus 6% interest and a note promising to pay $106, both misconstrues the question involved and over-simplifies the problem. The question for the Court to decide is whether Congress intended discount to be taxed differently than interest, not whether discount can in some cases be the financial equivalent of interest or what is the degree of equivalence in any particular case.

Discount is legally indistinguishable from bond premium, which is the amount by which the purchase price of a bond exceeds its face value. Yet this Court itself has established that bond premium is not to be taxed as if it were an interest item, but is rather to be reflected in capital gain or loss at the time of sale. To reach a contrary

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[4] Janin, *The Israeli Bond Ruling: Legislation By Administrative Fiat?*, 33 Taxes 191 (1955).

result with respect to discount would be unjustified in the absence of legislative authority such as that contained in § 1232 I. R. C. applicable to years subsequent to 1954. Other points raised by the Government are incorrect or irrelevant as demonstrated in "Argument" below. While Courts of Appeals other than the Sixth Circuit have upheld the result for which the Government contends, they have done so without the benefit of the extensive legislative and administrative history available, and without considering this Court's decisions establishing that the purchase of a bond for a premium is reflected only in capital gain or loss at the time of sale. The absence of any discussion in the opinions in these cases of these directly relevant materials makes them completely unpersuasive. The only court which has considered the relevant material is the District Court below, 214 F. Supp. 631 R. 18 (N. D. Ohio 1963), aff'd on the opinion below, 335 F. 2d 561 (6th Cir. 1964), which concluded in an extensive opinion that it was the clear intent of Congress that the gain involved here be taxed at capital gain rates.

In conclusion we submit that the Government asks this Court to legislate with respect to a period which Congress chose not to cover and in a manner different than Congress established for the future.

ARGUMENT.

I. PLAINTIFF IS ENTITLED TO A REFUND BECAUSE THE REALIZATION OF THE DISCOUNT AT WHICH A PRIVATE DEBT OBLIGATION IS ISSUED IS CAPITAL GAIN UNDER THE APPLICABLE 1939 INTERNAL REVENUE CODE PROVISIONS INTERPRETED IN ACCORDANCE WITH THEIR LEGISLATIVE HISTORY AND ADMINISTRATIVE CONSTRUCTION.

As a general rule, if the value of a capital asset increases due to the passage of time, no income results unless and until reflected in gain when the property is sold, and such gain is normally capital gain. This general rule is not altered by the fact that such increase in value may sometimes as a financial matter be similar to interest, as in the case of debt discount. Just last month the Treasury reaffirmed its longstanding position that a discount for advance payment of insurance premiums at a compound rate of three percent per annum is not interest, but merely reduces the cost of the policy.[5] Similarly, where stockholders buying stock on a rights offering are allowed a discount at the rate of six percent per annum in return for paying for the stock before it is issued, the discount is not interest, but a lessening of cost ultimately to be reflected in gain if the stock is sold.[6]

The Government seeks here to carve a narrow exception out of this well-established rule. It contends that when a debt instrument is purchased by an investor from the issuer at a discount below face value, the discount should

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[5] Rev. Rul. 65-24 I. R. B. 1965-6, p. 5, reaffirming I. T. 3513, 1941-2 Cum. Bull. 75.

[6] *Baltimore & Ohio R. R. Co. v. Commissioner*, 78 F. 2d 460 (4th Cir. 1935).

be taxed as if it were interest.[7] The applicable sections of the Internal Revenue Code of 1939, however, call for the opposite result.

The applicable Code provision in plain terms stated that: "the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis." Section 111(a) I. R. C. of 1939. If the asset is a capital asset, as has been stipulated here (R. 16), the "gain from the sale" is specially taxed either as long term or short term capital gain depending upon the holding period.[8] Section 117 I. R. C. of 1939.

Pursuant to these explicit provisions the taxpayer in its returns for 1952, 1953 and 1954 reported its gains from the sales of these notes as capital gain. Prior to the proposal for a change in these provisions in the Internal Revenue Code of 1954, we believe the Internal Revenue Service would not have questioned this treatment.

In adopting the revised 1954 Code Congress for the first time made explicit provision for corporate notes issued at a price less than their face amount. This new 1954 Code Section 1232 was applicable to the taxpayer's 1954 return, though not its 1952 and 1953 returns, and provided (as detailed below, pp. 31-32) that gain upon the sale of notes issued at more than a limited discount "shall be considered as gain from the sale or exchange of property which is not a capital asset," and hence not entitled to the special capital gain tax limitation, but only with respect to "bonds or other evidences of indebtedness issued after

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[7] No showing that the discount at which the various notes involved here were purchased was the same as interest would have been has been made in this case. It has been stipulated that a number of factors common to all investments in debt securities influenced the purchase price. R. 16.

[8] Both long term gain (R. 13-15) and short term gain (R. 14) are involved here.

December 31, 1954" (1954 Code Section 1232(a)(2)(A)). Thus the treatment of these gains reported in taxpayer's 1954 return did not differ from that under the 1939 Code.

The reasons which led the Internal Revenue Service to recommend to Congress that the Code be changed to provide that original issue discount when realized on sale should not be entitled to capital gain treatment, and which persuaded Congress so to provide with respect to evidences of indebtedness issued after December 31, 1954, were presumably those so forcefully presented in the Government's brief in this case. Presumably also, those same reasons also led the Internal Revenue Service to attempt to apply this new statutory provision retroactively and to assess tax on the taxpayer's profits from the notes as though they were ordinary income, not capital gain. Upon action by this taxpayer to secure a refund of the resulting tax which it paid, District Judge Kalbfleisch, with the unanimous concurrence of the Court of Appeals for the Sixth Circuit (R. 35), held that Sections 117 and 111 of the 1939 Code required capital gain treatment of the taxpayer's profits, and that 1954 Code, Section 1232 was applicable only prospectively with respect to notes issued after December 31, 1954 and was not, as the Government now contends, declaratory of prior law.

The House Ways and Means Committee, which wrote the 1954 Code, could not more clearly have denied the Government's proposition:

> "Under existing law any gain realized from a corporate or Government bond in registered form or with coupons attached is treated as a capital gain either if the bond is held to retirement or it is sold or exchanged. Part or all of this gain, however, may represent discount on original issue which is a form of interest income and in fact is deductible as an interest payment by the issuing corporation.

"Effective with respect to bonds issued after December 31, 1954, the committee bill provides that any gain realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income." H. Rep. No. 1337, 83rd Cong., 2d Sess. p. 83 (1954).[9]

The 1939 Code had earlier included one statutory exception treating a particular type of original issue discount as ordinary income to all taxpayers and another treating all such discount as ordinary income to a particular type of taxpayer, but neither of these exceptions apply here:

(a). Section 117(a)(1)(D) I. R. C. of 1939 specifically excepted from the definition of capital assets:

> "(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue."

Had this section not been limited to governmental obligations, it would have been directly applicable to the case at bar and would have required the result sought by the Government here without benefit of further legislation. It is noteworthy that this section refers to obligations issued "on a discount basis and payable without interest." There could hardly be a more conclusive demonstration that Congress recognized, as does the Government (Br. 12), the traditional usage of "discount" and "interest" as separate and distinct items, and that prior to 1954 Congress did not intend that discount on nongovernmental

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[9] The Senate Finance Committee report on the 1954 Code was not thus explicit with respect to the prior law.

debt obligations should be deprived of capital gain treatment.

(b). Section 207(d) I. R. C. of 1939 provided as to certain insurance companies:

> "The gross amount of income * * * from interest * * * shall be * * * increased by the appropriate accrual of discount attributable to the taxable year on bonds * * *."[10]

The applicable Regulations stated affirmatively that the taxation of discount to insurance companies as interest required by this special provision was different from the treatment of other corporations.[11]

Although other Regulations under the 1939 Code spelled out in vast detail various types of income, they never even implied that the discount at which debt obligations were originally purchased should be taxed to the holder of the obligations as if it were interest.[12]

It should thus be clear as a matter of interpretation of the statute and Regulations that the gain involved here was capital gain even without the support of legislative history and administrative practice. Any remaining doubt, however, is removed by examining these materials.

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[10] Section 207 I. R. C. of 1939 dealt with mutual insurance companies other than life or marine. Section 201(e) I. R. C. of 1939 contains a similar requirement applicable to life insurance companies.

[11] Reg. 39.207-1(a)(2) states: "The taxable income of mutual insurance companies subject to the tax imposed by section 207 differs of the taxable income from other corporations. * * * The gross amount of income during the taxable year from interest * * * [is] decreased by the appropriate amortization of premiums and increased by the appropriate accrual of discount * * *."

[12] The Commissioner for many years treated this gain as capital gain. pp. 12-14, *infra*. After he had changed his position in 1953 and after the enactment of § 1232 I. R. C. in 1954 a provision was inserted in the Regulations adopting the new theory. Reg. 1.61-7(c).

The legislative history is most helpful. Both houses of Congress have unequivocally stated their view that the gain attributable to debt securities purchased at a discount is a capital gain. In the Senate a 1929 debate on a proposal to exempt United States discount obligations from this capital gain clearly shows that it was understood that, even though discount could be financially equivalent to interest, it would be taxed as capital gain—undoubtedly in part because Undersecretary of the Treasury, Ogden Mills, so informed the Senate Finance Committee.[13] The District Court below, the first court considering the problem which seems to have been aware of this debate, stated as to it "* * * [this] legislative history indicates that appreciation resulting from this discount [on Federal Government bonds] was statutorily transferred into interest to avoid its taxation as capital gain." 214 F. Supp., at 636, R. 26. The full text of this debate is reproduced in the appendix.

Similarly, in 1938 a Subcommittee of the House Ways and Means Committee stated, in a report that resulted in the Internal Revenue Code of 1939, flatly that "A bond purchased at a premium results in capital loss when redeemed at par, and a bond purchased at a discount, in a capital gain." Appendix, p. 11a. This was followed in 1954 by the Ways and Means Committee's unqualified statement, quoted at pp. 8-9 above, that "existing law," the law in effect for the years here involved, treated gain from the obligations specified as capital gain even though it in-

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[13] Senator Couzens of Michigan stated: "The Undersecretary of the Treasury stated before the Finance Committee that the same identical bills of indebtedness, when traded in commerce, are subject to a profit tax. When a bill is traded in commerce, an acceptance, or what not, if there is a capital gain, it is taxed." June 4, 1929, Congressional Record, Senate, p. 2330.

cluded "discount on original issue." H. Rep. No. 1337, 83rd Cong., 2d Sess. p. 83 (1954).

Further confirmation of the legislative intent in enacting and re-enacting the 1939 Code is supplied by the numerous special provisions therein relating to other circumstances not directly involved here, both in regard to bond discount and its twin, bond premium[14]—enactments which would have been largely superfluous if the Government's present contentions represented the accepted law.[15] In fact, the understanding was so clear that H. R. 6999 was introduced in 1948 to tax the profit on United States Savings Bonds at capital gain rates so that they would have the same advantages as private bonds.[16]

It seemed apparent that the Treasury agreed that the realization of original issue discount resulted in capital gain, until about 1953 when the statute which changed this result prospectively was being drafted. The regulations dealing with insurance companies (see n. 10, *supra*), so indicated, and the Treasury many times ruled specifically that the realization of discount was capital gain. Contrary to the Government's contentions, these rulings were not all in the early history of the tax law. In 1952, only a year prior to the Treasury's change of position, it issued a private ruling stating, not only that discount should not be

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[14] See discussion of the treatment of bond premium. pp. 18-21 *infra*.

[15] Section 117(a) (1) (D), p. 9 *supra;* Section 201(e), p. 10, n. 11, *supra;* Section 207(d), p. 10 above; Section 42(b), allowing an election to taxpayers to report increases in the value of certain discount obligations annually; Section 42(c), providing that income from short term government discount obligations should not be taken into account until disposition of the obligations; Section 125, providing an election to amortize bond premium; Section 113(b) (1) (H), providing a reduction in basis for amortized bond premium.

[16] Appendix, *infra*. The background for the introduction of this Bill is given in 26 *Taxes* 775 (1948).

treated as interest for the purposes of the withholding tax on nonresident aliens, but also that if such discount was taxable at all to nonresident aliens it was taxable under the section of the law dealing with capital gains.[17] Similarly, in 1948 a private ruling was issued holding that discount on private bonds resulted in capital gain and explaining the statutory distinction which made the discount on Government bonds taxable as ordinary income.[18] Since private rulings are not generally reported, undoubtedly these rulings are only two of a number which were issued prior to the change of position in 1953. Cf. *Flora v. United States*, 357 U. S. 63, on rehearing 362 U. S. 145.

In 1920[19]—and in part again in 1922[20]—the Treasury held that such discount was not interest, should be reflected in gain or loss at the time of sale, and should not be treated as interest for withholding purposes. In 1927 the Treasury's then position was formally and vigorously presented to the Board of Tax Appeals, where it was upheld.[21] In 1929, as we have seen, the Undersecretary of the Treasury informed the Senate Finance Committee of this capital gain treatment. The last formal announcement of this position prior to the private rulings was the 1944 acquiescence in *Commissioner v. Caulkins*, 144 F. 2d 482 (6th Cir.,

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[17] 5 CCH 1952, Stand. Fed. Tax Rep. par. 6161. The meaning of this ruling is not clear without reference to § 211 (a) (1) (B), I. R. C. of 1939 (dealing with capital gains of aliens) and to the request for the ruling published at 5 CCH 1952, Stand. Fed. Tax Rep. par. 6284, all of which are reproduced in the Appendix.

[18] An extract from this Ruling was published at 26 *Taxes* 775 and is reproduced in the Appendix.

[19] O. 1024, 2 Cum. Bull. 189 (1920), O. D. 475, 2 Cum. Bull. 211 (1920).

[20] I. T. 1398, I-2 Cum. Bull. 149 (1922).

[21] *Corn Exchange Bank v. Commissioner*, 6 B. T. A. 158 (1927).

1944),[22] which had held that discount, when realized on the retirement of a non-interest bearing obligation, was capital gain.

The change of position in 1953[23] can hardly blunt the force of this record. As the court said in *Bliss v. Commissioner*, 68 F. 2d 890, 893 (2d Cir.) aff'd *sub nom. Helvering v. Bliss*, 293 U. S. 144 (1934):

> "The consistent administrative rulings of the commissioner from 1923 to 1932, during which time the provisions in question were thrice re-enacted, may properly be given weight by the courts. Brewster v. Gage, 280 U. S. 327, 336, 50 S. Ct. 115, 74 L. Ed. 457. *We do not think that the commissioner's subsequent about-face renders the principle inapplicable.*"[24]

The principle is equally applicable to private rulings. In *Hanover Bank v. Commissioner*, 369 U. S. 672 (1962), this Court said:

> "Furthermore, although the petitioners are not entitled to rely upon unpublished private rulings which were not issued specifically to them, [footnote omitted] such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws. And, because the Commissioner ruled, in letters addressed to taxpayers requesting them, that amortization with reference to a special call price was proper under the statute, [footnote omitted] we have further evidence that our construction of allowable bond premium amortization is

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[22] The Treasury acquiesces only in adverse Tax Court decisions and therefore technically the acquiescence was in the decision in the Tax Court, 1 T. C. 656 (1943), which the Sixth Circuit affirmed. 1944 Cum. Bull. 5.

[23] The change was first officially announced in Rev. Rul. 119, 1953-2 Cum. Bull. 95. Although the acquiescence was not withdrawn until 1955 (Rev. Rul. 55-136, 1955-1 Cum. Bull. 213); Rev. Rul. 119 limited the *Caulkins* case to its precise facts.

[24] Emphasis supplied throughout unless other indicated.

compelled by the language of the statute. [Footnote omitted]" 369 U. S. at 686-687.

Against this array of authority the Government relies almost entirely upon an over-simplified example and a series of three analogies which, upon examination, do not support its case.

II.

THE DEFENDANT'S THEORIES AND ARGUMENTS ARE WITHOUT MERIT.

Prior to discussing the theories upon which the Government does rely it is worth noting the authorities upon which it seems to place no great reliance. Beyond the cases pending in this Court, there are decisions by three Courts of Appeal,[25] the Court of Claims[26] and the Tax Court[27] apparently sustaining the Government's position. But none of these Courts came to grips with the real question involved, relying primarily instead on cases which the Government does not even cite.[28]

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[25] *Commissioner v. Morgan*, 272 F. 2d 936 (9th Cir. 1959); *Rosen v. United States*, 288 F. 2d 658 (3d Cir. 1961); *United States v. Harrison*, 304 F. 2d 835 (5th Cir.), cert. denied 372 U. S. 934 (1963).

[26] *Pattiz v. United States*, 311 F. 2d 947 (Ct. Cl. 1963).

[27] *Gibbons v. Commissioner*, 37 T. C. 569 (1961); *Schwartz v. Commissioner*, 40 T. C. 191 (1963).

[28] These courts relied principally on the principle that the sale of an ordinary income item does not convert it to a capital gain *without examining whether they were dealing with an ordinary income item*. *Cf. Rosen v. United States*, *supra*, which alone contains a superficial discussion of the real issue. For this principle the cases largely relied on *United States v. Snow*, 223 F. 2d 103 (9th Cir. 1955), cert. denied 350 U. S. 831; *Helvering v. Horst*, 311 U. S. 112; *Tunnell v. United States*, 259 F. 2d 916 (3d Cir. 1958) and *Hort v. Commissioner*, 313 U. S. 28, none of which are cited by the Government, as well as *Commissioner v. P. G. Lake, Inc.*, 356 U. S. 260; *Fisher v. Commissioner*, 209 F. 2d 513 (6th Cir. 1954) and *Commissioner v. Phillips*, 275 F. 2d 33 (4th Cir. 1960) which the Government does cite.

It cannot be denied that as a matter of numbers the Second Circuit, in *Dixon*, 333 F. 2d 1016, pending on petition for writ of certiorari, No. 486, this term, has more support than the Sixth Circuit in the case at bar, but at the same time it cannot be overemphasized that this is a matter of numbers only. Examination of the briefs in the cases decided by the other Circuit Courts and the Court of Claims reveals that they were not informed of the published rulings of the Treasury in 1920[29] and 1922, the Senate debate in 1929, the House of Representatives Subcommittee Report in 1938, the unpublished rulings in 1948 and 1952, the decisions of this Court dealing with bond premium[30] and the Tax Court's decision in the *Corn Exchange Bank* case.

Understandably, the Government virtually ignores the decisions exhibiting such a massive lack of information and seeks instead to support its case with irrelevant and inapplicable materials. This will not do. Its case must stand or fall on this unreasoned authority, for it has no other.

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[29] One of these rulings (O. 1024, 2 Cum. Bull. 189 (1920)) was cited by the taxpayer in *United States v. Harrison*, 304 F. 2d 835 (5th Cir. 1962), cert. denied 372 U. S. 934.

[30] One of the four decisions, *Old Colony R. Co. v. Commissioner*, 284 U. S. 552, was cited for a different point by the Government in *Pattiz v. United States*, 311 F. 2d 947 (Ct. Cl. 1963), and *Commissioner v. Morgan*, 272 F. 2d 936 (9th Cir. 1959) and by both parties in *Rosen v. United States*, 288 F. 2d 658 (3d Cir. 1961).

1. The Government's Example Both Misconstrues the Question Involved and Oversimplifies the Question to Which It Is Addressed, as Evidenced by Established Law as to Bond Premium.

The Government's principal argument is that a $100 note with 6% interest is financially equivalent to the purchase of a $106 note for $100. This example would be relevant here only if the question involved were the degree of similarity between discount and interest. But this is not the question presented. The question is whether Congress intended discount to be taxed as if it were interest.

The Government's example has been unrealistically constructed, so that (putting aside prepayment and default situations, bankruptcy, priorities, usury statutes and creditors' rights)[31] the discount involved is the exact financial equivalent of the interest with the result that there is a formal difference only. Even conceding, for this purpose, that the difference is largely a formal one, the Government's argument must fail, for formal differences are often determinative in this intricate area of the tax law. For instance, for many years very substantial differences in tax treatment have depended upon whether a debt instrument

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[31] Substantial differences exist in these areas. Section 63(a) of the Bankruptcy Act (11 U. S. C. § 103(a)) provides that non-interest-bearing debts not due at the date of bankruptcy must suffer "rebate of interest" which is at the legal rate. *Collier on Bankruptcy* Par. 63.16, pp. 1856-7 (14th ed.). See *In re Orne*, Fed. Cas. No. 10,581 (S. D. N. Y. 1867); *cf. Illinois Steel Co. v. O'Donnell*, 156 Ill. 624, 41 N. E. 185, 186 (1895) where a "just and equitable" rebate was required. On the other hand interest-bearing obligations simply bear no interest after the filing date. Thus where the interest-bearing note bears a rate less than the legal rate a discount obligation will be at a disadvantage in bankruptcy. Similarly, usury statutes are held not to prevent a discount at the full legal rate even though a "yield" in financial terms exceeds the legal rate. 2 *Restatement of Contracts*, Section 534(a) (1932); 6 *Williston on Contracts*, Section 1695, p. 4797 (Rev. Ed. 1938).

was in registered form[32] and the Treasury itself insisted prior to the 1964 Revenue Act that in the case of discount obligations issued for property even the mere "name" (Br. 13) given to the payments is decisive,[33] an interpretation which Congress specifically approved. In discussing the provision which became Section 483 I. R. C. the Ways and Means Committee stated in 1963, "This treats taxpayers differently in what are essentially the same circumstances merely on the grounds of the names assigned to the payments." [34]

Despite a profusion of different examples expressing a payment of $100 in return for a promise to repay $106 in a year's time, the Government neglects to mention one situation which makes the point well. A bond purchased for $100 promising to pay $94 plus $12 interest in a year would also be financially equivalent to the Government's example. Yet it is clear, where the obligation is purchased at more than par—at a premium—that the tax result, in the absence of a statutory election, would be a *capital loss* of $6 and interest income of $12.[35] If the taxation of investment securities is to be determined by simple illustrations purporting to show economic equivalence, the result in this situation should simply be $6 of interest income and no capital loss. But settled law, including several

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[32] Section 117(f) I. R. C. of 1939, which provided that a retirement should be treated as a sale or exchange, was limited in its application to corporate obligations which either were registered or bore interest coupons. Section 165(g) I. R. C. similarly limits losses from worthless securities to such debt instruments. Section 125 I. R. C. of 1939 also limited amortization of bond premium to such instruments.

[33] I. T. 2674, XII-1 Cum. Bull. 96, 97 (1933).

[34] H. Rep. No. 749, 88th Cong., 1st Sess., p. 72 (1963).

[35] *New York Life Insurance Co. v. Edwards*, 271 U. S. 109. Under § 171 I. R. C. and its predecessors the taxpayer is now permitted to elect to amortize bond premium.

decisions of this Court,[36] requires the capital loss result, and refutes the Government's illustration.

The premium and discount situations are legally indistinguishable. The question in both cases is whether the difference between the purchase price and the face value of a debt obligation was intended by Congress to be taxed as if it were interest, instead of being reflected in gain or loss at the time of sale.

Obviously it would require most specific statutory language to compel tax results for purchases of bonds above face value different from those for purchases below face value. In fact there was no suggestion of such a difference, either to the issuing corporation or the investor, until the Treasury changed its position on the question involved here in 1953. On the contrary, the General Counsel of the Bureau of Internal Revenue had said in an official ruling: "It seems obvious that the treatment of premium is analogous to that of discount, and, therefore, the Bureau rulings on the treatment of discount are in point." G. C. M. 1455, VI-1 Cum. Bull. 87, 88 (1927). And one of the first rulings holding that original issue discount affected only capital cost of the obligation explicitly stated that the tax treatment of *both premium and discount* allowed to the issuing corporation could not be used for either by the investor. O. D. 475, 2 Cum. Bull. 211 (1920).

This Court first rejected the arguments the Government makes here in a case involving premiums in *New York Life Insurance Co. v. Edwards*, 271 U. S. 109. The taxpayer in that case attempted to reduce the interest it received on bonds purchased at a premium by the appro-

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[36] *New York Life Insurance Co. v. Edwards, supra; Old Colony R. Co. v. Commissioner*, 284 U. S. 552; *Commissioner v. Korell*, 339 U. S. 619; *Hanover Bank v. Commissioner*, 369 U. S. 672. Acc. Rev. Rul. 55-641, 1955-2 Cum. Bull. 294.

priate amortization of the premium, arguing that the bonds were financially equivalent to a lower priced bond with a lower interest rate. The Court held that the premium could not be amortized and that the loss was allowable only upon the sale or other disposition of the obligations.[37]

When Congress chose in 1942 to authorize an election to amortize debt premium as a reduction of interest income, it made careful and explicit provisions as to the exact circumstances where this would be permitted, as it had done in the case of short-term government discount bonds and in the case of insurance companies. The election under Section 125 I. R. C. of 1939 was limited to evidences of indebtedness (i) issued by a corporation (including government or political subdivision), (ii) bearing

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[37] In *Old Colony R. Co. v. Commissioner*, 284 U. S. 552, the Court considered essentially the same argument which the Government makes here, as follows (pp. 558-59):

> "The conclusion is that the actual return to one who pays a premium is less than the nominal interest carried by the bond, and to one who buys at a discount is greater than such nominal rate. The argument is that although the regulations are inaptly phrased and are susceptible of the construction petitioner places upon them their real intent was to adjust the nominal interest paid on a corporation's indebtedness to the actual amount it is paying for the use of the money represented by the par of the bond,—that is, to what accountants have called the 'effective rate' of interest."

The Court rejected this argument, saying (p. 561):

> "We cannot believe that Congress used the word having in mind any concept other than the usual, ordinary and everyday meaning of the term, or that it was acquainted with the accountants' phrase 'effective rate' of interest and intended that as the measure of the permitted deduction."

Following the 1942 statutory authorization for an investor to elect to amortize bond premium (Section 125 I. R. C. of 1939), this Court held in *Commissioner v. Korell*, 339 U. S. 619 that a premium paid for a conversion privilege was amortizable on the theory that there was no warrant for distinguishing among different reasons for the payment of premium. See also *Hanover Bank v. Commissioner*, 369 U. S. 672.

interest, and (iii) with interest coupons or in registered form, and (iv) explicit exclusions are made with respect to dealers. Further, Congress was careful to make a correlative provision with respect to the adjustment of the basis of the debt obligation, adding subparagraph (H) to 1939 Code Section 113(b)(1).

It required this specific and detailed legislation to permit the treatment of bond premium as an offset to interest. Yet the Government asks this Court to hold that discount can be similarly treated in the face of a deliberate refusal by Congress so to legislate under the Internal Revenue Code of 1939.

2. **The Government Wrongly Ignores the History of Treatment of Bond Discount to the Investor as Capital Gain Prior to the Treasury's Change of Position.**

The Government states that discount has historically been taxed as if it were interest and then argues that it is permissible to ignore all directly relevant materials prior to 1953 because, it says, it was not decided until that year that the proceeds of the sale of a bond with stated interest could be allocated in part to interest and taxed as ordinary income (Br. 24-25, 31-32). For this reason it argues that we must look to analogous areas to decide this case and relies on three purported analogies, hereinafter considered, instead of discussing the directly relevant authorities.

This argument, however, cannot stand in the face of settled history on the taxation of the sale of interest bearing bonds together with the accrued interest. The tax consequences of bond sales between interest dates, amounting to millions of dollars each day, were certainly known prior to 1953. The obvious allocation was originally required in 1920, Sol. Op. 46, 3 Cum. Bull. 90, and by 1938 the Treasury could state with confidence, "It is

well settled, therefore, that where bonds are sold between interest dates the accrued bond interest to the date of sale is taxable to the person who sells the bonds," I. T. 3175, 1938-1 Cum. Bull. 200, 201. This principle has never been challenged before or since. The sole dispute was in the treatment of bonds in default which were sold "flat." [38] Under these circumstances, if the contention that the court need consider only post-1953 materials had any validity in the first place, it falls with its premise.

A further obstacle to the Government's contention that the court need consider direct authorities only if they were decided after 1953 is that for the period from 1944 to 1955[39] the Treasury acquiesced in the decision in *Commissioner v. Caulkins*, 1 T. C. 656, aff'd. 144 F. 2d 482 (6th Cir. 1944) that discount realized on the retirement of a debt obligation resulted in capital gain. Both courts below cited this case as authority for their decisions, and for the proposition that discount when realized properly constitutes only capital gain or loss. The Government meets this obstacle by interpreting the acquiescence in the *Caulkins* case as resting solely on the fact that a retirement rather than a sale was involved. Stripped of its verbiage, the Government would have us believe: that the Sixth Circuit Court of Appeals was "plainly mistaken" (Br. 27) and committed an "obvious error" (Br. 28) in *Caulkins* with-

[38] See Br. 29 n. 20, 8 n. 2. The Government cites *Jaglom v. Commissioner*, 303 F. 2d 847 (2d Cir. 1962); *Fisher v. Commissioner*, 209 F. 2d 513 (6th Cir.), cert. denied 347 U. S. 1014 (1954), *United States v. Langston*, 308 F. 2d 729 (5th Cir. 1962); and *First Ky. Co. v. Gray*, 309 F. 2d 845 (6th Cir. 1962), all of which involved defaulted bonds sold flat. It also cites *Arnfeld v. United States*, 163 F. Supp. 865 (Ct. Cl. 1958), cert. denied 359 U. S. 943; and *Commissioner v. Phillips*, 275 F. 2d 33 (4th Cir. 1960) which involved the wholly different issue of the tax treatment of insurance and annuity policies.

[39] Acquiescence 1944 Cum. Bull. 5, withdrawn Rev. Rul. 55-136, 1955-1 Cum. Bull. 213.

out even reaching the question involved here; that the Treasury was sufficiently ignorant of the tax law to acquiesce in this "obvious error" for over ten years;[40] that the Court in *Caulkins* held that discount is interest (Br. 27) even though it did not reach that question; and finally that the Sixth Circuit in the case at bar, which involved a sale—the purported distinguishing feature—misinterpreted its prior decision in *Caulkins*. The resort to an interpretation involving such a series of unlikely assumptions reveals the weakness of the Government's case.

But the Treasury's action is the best evidence that the assumptions are unfounded. Its acquiescence was in the Tax Court decision, 1 T. C. 656, the holding in which that the obligations were "within the capital gains provision unless expressly excluded," (*id* at 662) must have been clear to the Treasury, and should therefore be obvious to the Government here.

Even if the *Caulkins* case stood alone, therefore, the Government's explanation of it would not hold up under examination. But *Caulkins* does not stand alone. Something of a pattern is established by acquiescences in 1942 and 1944 in decisions in two other cases holding that discount gain was not interest for personal holding company purposes[41]—neither case involving the application of § 117 (f). And in *Caulkins* itself in the Tax Court the Government's attorney in effect refuted the Government's current interpretation by conceding that United States Savings Bonds would yield capital gain in the absence of a specific

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[40] In cases where the Treasury agrees with the result of a case but not with its implication it acquiesces "in result only." See *e.g.*, *Brink, et al. v. Commissioner*, 42 B. T. A. 765, acq. as to result only, 1944 Cum. Bull. 4.

[41] *Western Acceptance Corporation v. Commissioner*, 46 B. T. A. 828, acq. 1942-2 Cum. Bull. 19; *Elk Discount Corporation v. Commissioner*, 4 T. C. 196, acq. 1944 Cum. Bull. 8.

statute;[42] a view reaffirmed only a few years later in a private ruling (26 *Taxes* 775 (1948) Appendix 33a).

Putting all these elements together there is no remaining doubt as to the holding of the *Caulkins* case and meaning of the acquiescence in it. The plain facts are that in 1944 the Tax Court and Sixth Circuit held that the realization of the discount at which a debt obligation was purchased was capital gain, and the Treasury agreed, at least until 1953.[43]

3. The Government's Reliance on the Deductibility of Discount by the Issuing Corporation as Analogous Authority is Without Merit Since Many Deductible Payments Are Not Ordinary Income to the Payee.

The Government cites, as virtually its only authority, cases holding that discount and commissions on the sale of bonds are deductible to the issuer over the life of the bonds (Br. 14-16). These cases can be of no aid to a decision here since it is clearly established that the issuer and the investor are not treated alike.

It should be obvious that the Government's argument proves too much from its citation (Br. 15) of *Helvering v. Union Pacific Co.*, 293 U. S. 282. This decision did not involve discount at all, but solely commissions paid to brokers for their services in selling bonds. Obviously the fact that the issuer can deduct these payments over the life of bonds has no effect on the income of the bondholder.

This principle is readily apparent where a securities dealer purchases securities from an investor, where a

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[42] 1 T. C. 656, 662.

[43] In 1953 the acquiescence was limited to the precise facts of the *Caulkins* case by Rev. Rul. 119, 1953-2 Cum. Bull. 95. The ruling held that bonds of the State of Israel, similar to United States Savings Bonds, yielded ordinary income rather than capital gain when redeemed. See Janin, *The Israeli Bond Ruling: Legislation by Administrative Fiat?*, 33 *Taxes* 191 (1955).

manufacturer purchases a building or equipment from a prior owner, where a corporation purchases supplies such as timber and coal from a landowner, where a patent is purchased from an inventor, and in many other cases. Such expenditures as well as the discount at which debt obligations are issued, are costs to the payor and, of course, result in deductions by it from ordinary income. But this deduction does not affect the capital gain treatment of the payments.

The converse of the bond discount case is the receipt of a premium on the issuance of bonds, where it is clear that the issuer has ordinary income (Reg. 1.61-12(c) (2)) and the investor has a capital loss (Rev. Rul. 55-641, 1955-2 Cum. Bull. 294) if the statutory election is inapplicable.

The Treasury itself has pointed out that the different parties are not to be treated alike in O. D. 475, 2 Cum. Bull. 211 (1920) which held that the amortization of premium and discount allowed to the issuer was not available to investors. Furthermore, the deduction for discount is properly allowable to the issuer as a loss and not, as the Government would imply, as interest.[44]

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[44] Mertens states: "Bond discount is founded upon the concept of compensation for a prospective loss." 2 Mertens *Law of Federal Income Taxation*, § 12.109 Ch. 12, p. 345; Molloy, *The Ambiguous Tax Nature of the Various Costs of Borrowing Capital*, 11 Tax Law Review, 373, 399-400 (1956), concludes that the weight of authority is that the deduction is allowed as a loss.

Where the distinction between a loss deduction and an interest deduction has been critical, the Treasury has been successful in requiring loss treatment. See, *e.g.*, *Atlanta & Charlotte Air Line Ry. Co. v. Commissioner*, 36 B. T. A. 558, 561, acq. 1937-2 Cum. Bull. 2, which stated:

"The Commissioner regards bond discount primarily as a loss.

* * * * *

These regulations are interpreted by the Supreme Court as classifying discount as a loss sustained on payment of the bonds at maturity. *Helvering v. Union Pacific R. Co.*, 293 U. S. 282."

4. The Government's Reliance on the Taxation of Municipal Bonds as Analogous Authority Is Without Merit.

The Government cites as an analogy favoring it the taxation of the discount at which municipal or state bonds were issued. The rulings cited by the Government, and many others, were all specifically and clearly limited to the exemption from tax of income or gain, rather than dealing generally with the question whether discount is to be taxed as if it were interest.[45] As the District Court observed, 214 F. Supp. at 636 (R. 25), it is obvious from this limitation that constitutional considerations played a decisive role.

In 1931, in a case deciding that capital gains (other than discount) on state bonds could be taxed, the constitutional theory was stated by this Court as follows:

> "In the case of the obligations of a State or of its political subdivisions, the subject held to be exempt from federal taxation is the principal and interest of the obligations. *Pollock v. Farmers' Loan & Trust Company, supra.* These obligations constitute the contract made by the State, or by its political agency pursuant to its authority, and a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of the government." *Willcuts v. Bunn,* 282 U. S. 216, 226.

Under this theory any amount promised by a state was exempt, whether principal, discount or interest. It is

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[45] The clear implication of these rulings was, in fact, that in the absence of constitutional considerations the gain was a capital gain. G. C. M. 1455, VI-1 Cum. Bull. 87, 89 (1927) stated: "The amount for which the bonds are purchased without regard to any discount or premium element therein is to be taken as the

(Continued on following page)

not significant therefore that discount on state obligations was taxed in the same way as interest.[46] It could be argued with equal force that it was taxed in the same way as principal.

5. The Government's Reliance on Purported Accrual to an Accrual Basis Taxpayer as Analogous Authority Is Without Merit.

The final alleged analogy upon which the Government relies is the purported accruability of discount as income to an accrual basis taxpayer. The Government contends that such an accrual is required (Br. 37-39), but this surely is not, and never was, the law. Only last year, in connection with statutory changes in the taxation of insurance companies, the Senate Finance Committee stated:

> "Stock fire and casualty insurance companies on the other hand, and *corporations generally, are not required to accrue discount (either that arising at the time of issue or market)* on bonds purchased at a discount by them." S. Rep. No. 830, 88th Cong., 2d Sess. p. 122 (1964).

As is normally the case, this report was probably written with the advice of tax experts from the Treasury Department and reflects their views. Writers in the field unanimously understood that no accrual was required, or even permitted. Even the law review article cited by the Government (Br. 40 n. 37) for its proposition sets forth "* * *

(Continued from preceding page)

basis for determining gain or loss on their sale or redemption (O. D. 726, C. B. 3, 49), any profit realized being a profit resulting from the conversion of a capital asset and any loss sustained being deductible."

[46] Nor is it significant that the rulings do not speak in terms of constitutional limitations in view of the Treasury's longstanding opposition to the exemption.

the Federal rule that neither premium nor discount on bonds is to be amortized by the purchaser." [47]

Close examination of the Government's brief and the authorities cited in it reveals nothing contrary in regard to investors. It cites and promptly dismisses as incorrect, O. D. 475, 2 Cum. Bull. 211 (1920), which established the rule that discount could not be accrued, and *Corn Exchange Bank v. Commissioner*, 6 B. T. A. 158 (1927), the landmark case, where the Treasury succeeded in preventing a bank acting as an investor from amortizing either discount or premium. There the court said (pp. 161-162):

"We think, however, that no accrual can be predicated on the premium or discount at which a bond is purchased before the bond is sold or redeemed. Before sale or redemption of a bond nothing occurs to fix the amount which the holder thereof will actually realize from it.

* * * * *

"The same consideration governs in determining the proper basis to be employed in computing gain or loss on the sale of the bonds under the 1921 Act as under the 1913 Act. The basis prescribed by the

[47] Brandis, *Effect of Discount or Premium on Bondholder's North Carolina Income Tax*, 19 No. Car. L. Rev. 1, 4 (1940), cited at Br. 19, 40 (as corrected) as "*Effect of Discount or Premium*." Other writers are equally clear. Mertens, for instance, says at Ch. 23, Section 23.162, p. 298 n. 31:

"The Code is silent as to how discount on bonds purchased is treated for tax purposes. The established rule is, however, that the basis for determining gain or loss on disposition of the bond is the amount paid therefor. No part of the discount can be treated as income prorated over the life or term of the bond."

See also Paton, *Advanced Accounting* (1941) p. 196; *Accountant's Handbook* (2d ed. 1939), p. 339; Newlove, *Intermediate Accounting* (1939 ed.), p. 205; Lawrence, *Bond Discount Treatment Under the 1942 Revenue Act*, 21 *Taxes* 651 (1943).

statute for computing gain or loss is cost. * * * Unlike depreciation, the annual amortization of premium or discount on securities of other corporations held for investment is not an allowable adjustment to income, nor an allowable adjustment to the basis for computing gain or loss on sale. See *Appeal of Even Realty Co.*, 1 B. T. A. 355."

The Government seeks to minimize the impact of this case by pointing out that the Board nowhere says explicitly whether original issue discount or market discount bonds were involved. But the opinion does seem rather clearly to deal with all the bonds in the Bank's investment portfolio and it is difficult to imagine that both types of discount and premium would not be involved in the portfolio of such a bank.[48]

In an attempt to establish a contrary rule, the Government cites three rulings, of which two involved United States obligations as to which statutes in terms treated discount as if it were interest and the third did not involve discount at all.[49] Beyond this the Government cites only

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[48] As the District Court in the instant case put it: "[A]n examination of both the facts and the opinion in the Corn Exchange Bank case fails to reveal that the Court there was discussing any particular kind of discount. A practical examination of the transactions involved leads the Court to conclude that it is extremely likely that both kinds of discount were involved." 214 F. Supp., at 636 (R. 25).

[49] T. D. 3301, I-1 Cum. Bull. 100 (1922), dealt with Treasury Savings certificates issued under a statute which in terms described the excess of the face amount over the purchase price as "interest to maturity" and G. C. M. 15875, XIV-2 Cum. Bull. 100 (1935), as the Government itself admits, dealt with United States Savings Bonds issued under a statute which specifically provided that the discount "shall be considered as interest."

Finally, I. T. 1684, II-1 Cum. Bull. 60 (1923), seems to have involved a redeemable bank deposit upon which interest or dividends were credited annually, but which, if left on deposit for a sufficient time, would double in value. Since neither discount nor gain are even mentioned in the ruling, it is difficult to see how it is relevant to the present issue. See I. T. 2924, XIV-2 Cum. Bull. 135 (1935) for a fuller explanation of what seem to be the facts.

cases and rulings dealing with permissible accounting methods for commercial loan departments of financial companies.[50] Since none of these authorities concerns either capital assets (because the taxpayers were in the business of dealing with these obligations) or sales or exchanges, it is difficult to see their relevance.

The short of the matter is that the Government has established the existence of a permissible accounting method applicable to the unique circumstances of a commercial lender holding discount loans in the regular course of its business, and has misconstrued this as establishing a general rule applicable to discount under all circumstances.

While the treatment of discount in other situations does not have the relevance which the Government implies, it should be pointed out that under most circumstances discount has been treated differently from interest. For instance, the deduction of discount has been held not to be subject to a statutory limitation on the deduction of interest. A. R. R. 880, I-1 Cum. Bull 276 (1922). Similarly it has been held that discount does not qualify as interest paid for the purpose of computing a life insurance company reserve interest credit. *Standard Life Insurance Co. v. United States*, 62-1 U. S. T. C. para. 9404 (S. D. Ind. 1962).

The Government's brief itself devotes two pages (Br. 18-20) to a discussion of whether market discount ought to be treated as it says original issue discount should be

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[50] *Chatham & Phenix National Bank v. Commissioner*, 1 B. T. A. 460 (1925) (bank); S. M. 3820, IV-2 Cum. Bull. 32 (1925) (bank); *Chicago Acceptance Co. v. Commissioner*, 12 B. T. A. 150 (1928) (finance company); *Vancoh Realty Co. v. Commissioner*, 33 B. T. A. 918 (1936) (finance company); *Motors Securities Co., Inc. v. Commissioner*, decided October 30, 1952 (P-H Tax Ct. Mem. Dec. Para. 52,316) (finance company).

treated, or continued to be recognized as capital gain when realized, as finally the Government admits it must be. The Government attempts no argument that ordinary market discount is anything other than compensation for the use of money. The fact that the compensation is received by the investor from someone other than the borrower is wholly immaterial; certainly interest on an ordinary interest bearing note paid by someone other than the maker could not be excluded from the noteholder's income.

As the Government also well recognizes (Br. 20-21), the purchase of property on a deferred payment basis at a stated price higher than would have been exacted if a cash payment had been made involves compensation for the use of money payable by the buyer of the property to the seller of the property, in exactly the same sense that debt discount involves compensation payable by the borrower to the lender. Yet the Treasury Department does not assert, and courts do not hold, that any part of the payments received by the seller should be considered as interest income except as the interest element is separately identified. It appears from the Government's discussion that in this instance it is content to let Congress' legislative solution of the matter, which was finally determined upon only in 1964, be given the prospective effect which Congress intended.

Moreover, application of the Government's theory to § 1232 of the 1954 Code would remove the limitations carefully prescribed by Congress. This statute applies only to corporate obligations, only if the obligation has been held for more than six months[51] and only if the dis-

[51] In cases where taxpayers have other capital losses which would be deductible only against capital gain, whether long or short term, this distinction is most important, since under § 1232 gain from the sale of obligations held less than six months is a short term capital gain.

count rate is greater than ¼th of 1% per annum. It does not apply at all if the particular holder has paid a premium. The Government's theory, which requires discount to be treated as interest for tax purposes and to be accrued on a daily basis, on the other hand, must apply to discount in any amount on obligations issued by any taxpayer and regardless of holding period or cost to the holder. Further, the whole concept of Section 1232 and its very language assumes that the discount realized by sale or redemption is part of the gain on the disposition of the note—not income accruing during the period the note was held as the Government now asserts.

Obviously the Government's theory and the Congressional enactment cannot stand together. If the Government believes that the provisions of the 1954 Code have not yet properly provided for ordinary income treatment of original issue discount it should present its arguments to the Congress, not to this Court.

The statement of the Court in *Hanover Bank v. Commissioner*, 369 U. S. 672, at 682, is particularly apt here.

> "The Government's primary reason for urging this interpretation of Section 125 is that the statute has created a tax loophole of major dimension that should be closed short of allowing the deduction sought in this case. *While this assertion might have been persuasive in securing enactment of the amendments to the statute made subsequent to the time the transactions involved here took place (see discussion, infra), it may not, of course, have any impact upon our interpretation of the statute under review.* We are bound by the meaning of the words used by Congress, taken in light of the pertinent legislative history. In neither do we find support for the Government's interpretation."

Presumably the Treasury's similar assertions that discount is, in some cases, economically the equivalent of interest were persuasive in securing the enactment of Section 1232 of the 1954 Code. They should not be persuasive in securing retroactive application to this case of that provision, or of some substitute principle said to produce the same or a better result.

CONCLUSION.

For the reasons stated, the judgment of the Court of Appeals for the Sixth Circuit should be affirmed.

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